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The Enforceable Prepayment Penalty

Robert Boyle*

“We certainly don’t want there to be a fine print preventing people from owning their home. We can change the print, and we’ve got to.”¹

–President George W. Bush

I. INTRODUCTION

In the early part of this decade, the housing market became erratic. Investors flocked to real estate. Property values increased despite an abundance of inventory. The lending industry created tens of millions of mortgages. Like some modern day gold rush, homeownership beckoned to rich and poor alike. The government watched on with disinterest as the number of subprime mortgagors leapt.²

In the past two years, the housing market came to a screeching halt. Havoc ensued. Millions of Americans find themselves trapped in mortgages they cannot afford. Washington, mired in fear of a recession and deafened by the cries of wounded investors, has done little to help. A President who once spoke loftily of promoting homeownership has fallen silent.³ While Congress debates a permanent solution, the judiciary can provide much-needed relief to the American people. The courts should consider subjecting the prepayment provisions found in many mortgages to a liquidated damages analysis. This would invalidate a number of the most unconscionable prepayment provi-

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1. President George W. Bush, Remarks by the President on Homeownership (June 17, 2002) (transcript available at <http://www.whitehouse.gov/news/releases/2002/06/20020617-2.html>).

2. In 2004, Edward Gramlich, a former Governor of the Federal Reserve, explained, “[i]ncreased subprime lending has been associated with higher levels of delinquency, foreclosure, and in some cases, abusive lending practices.” Paul Krugman, *A Catastrophe Foretold*, N.Y. TIMES, Oct. 26, 2007. As early as 2000, Mr. Gramlich tried, to no avail, to convince Alan Greenspan to increase oversight of subprime lending. *Id.*

3. See, e.g., President George W. Bush, Remarks by the President on Signing the American Dream Downpayment Act (Dec. 16, 2003) (transcript available at <http://www.presidency.ucsb.edu/ws/index.php?pid=64935>). “This administration will constantly strive to promote an ownership society in America. . . . It is in our national interest that more people own their own home. After all, if you own your own home, you have a vital stake in the future of our country.” *Id.*

sions and give cash-strapped homeowners an opportunity to salvage something from their investments.

II. BACKGROUND

A. *The Dream, the Bubble, and the Burst*

Homeownership is the most significant investment most Americans will ever make.⁴ Home equity provides borrowing power to finance important needs such as education.⁵ Homeownership bestows a myriad of social benefits and diminishes the strain on the welfare system.⁶ Successive presidents have equated homeownership with the American dream,⁷ and Congress has incentivized⁸ the dream, increasing its allure.⁹ The government subsidizes¹⁰ homeownership in order to make it affordable for middle-class Americans.¹¹ President George W. Bush

4. "A home is the largest financial investment most American families will ever make, and it allows families to build financial security as the equity in its home increases." The White House, President George W. Bush, Background, <http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-background.html> (last visited Oct. 10, 2008).

5. "[A] home is a tangible asset that provides a family with borrowing power to finance important needs, such as the education of children." *Id.*

6. "Accumulation of substantial net worth through a lifetime of home ownership means retirees are less dependent on both social security and retirement programs as a source of income in their retirement years." The American Homeowners Grassroots Alliance, Tax Incentives for Home Ownership, <http://www.americanhomeowners.org/AHGA/AHGA%20Issues/Taxincentives.htm>.

7. According to President William J. Clinton:

Owning a home is central to the American dream. . . . My administration has worked hard to help more Americans own their own home. . . . I am determined to press forward with our economic strategy, so that our economy keeps growing and millions more families can join the ranks of homeowners.

President William J. Clinton, Statement on the Expansion of Homeownership (Oct. 22, 1996) (transcript available at http://findarticles.com/p/articles/mi_m2889/is_n43_v32/ai_19037122). President George W. Bush shared President Clinton's desire to expand homeownership. See *supra* note 1.

8. "Homeowners receive considerable assistance from the federal government in the form of income tax benefits." Congressional Budget Office, *The Tax Treatment of Homeownership: Issues and Opinions*, CONGRESS OF THE UNITED STATES CONGRESSIONAL BUDGET OFFICE, at xi (1981). The tax laws allow homeowners to deduct mortgage interest and property taxes from their taxable income and reduce their capital gains tax liabilities. *Id.* An additional benefit comes from the non-taxation of net imputed rental – "the difference between the income they could receive from renting their homes and the total costs of homeownership." *Id.*

9. "By lowering the after-tax cost of homeownership, the tax provisions tend to shift resources into housing at the expense of other capital assets, and into the production of owner-occupied housing rather than rental housing." *Id.* at xii.

10. "The federal government spends more than \$150 billion each year to subsidize homeownership." TAX POLICY CENTER, THE TAX POLICY BRIEFING BOOK, (2008), <http://www.taxpolicycenter.org/briefing-book/key-elements/homeownership/incentives.cfm>.

11. "These tax provisions reduce the after-tax costs of acquiring, owning, and selling a home." Congressional Budget Office, *supra* note 8, at xii. *But see* THE TAX POLICY BRIEFING BOOK, *supra* note 10 ("The bulk of the subsidies go to middle- and upper-income households who

has commonly used homeownership figures as a litmus test for the nation's economic health.¹² Unfortunately, the rampant increase in homeownership helped create the current economic crisis. Washington's quest to inflate the number of homeowners deflated the economy.

The real estate market entered a prolonged boom during the early part of this decade.¹³ While speculative investors powered much of this market boom,¹⁴ first-time buyers also had an impact.¹⁵ With the annual appreciation rate of real estate reaching double digits, an unprecedented number of Americans felt the need to become homeowners.¹⁶ The government successfully made homeownership more accessible, but it left no guardrails to keep people from sliding into debt.

Traps lay in wait for unsuspecting buyers. Lenders accepted mortgages without down payments—even from mortgagors unable to make their first premium payments. Banks advised mortgagors to take

would likely own their homes anyway; thus, these subsidies simply facilitate the consumption of more housing.”).

12. See President George W. Bush, State of the Union Address (2004) (transcript available at <http://www.whitehouse.gov/news/releases/2004/01/20040120-7.html>) (“The pace of economic growth in the third quarter of 2003 was the fastest in nearly 20 years; new home construction, the highest in almost 20 years; home ownership rates, the highest ever.”). See also The White House, President George W. Bush, Record of Achievement, <http://www.whitehouse.gov/infocus/achievement/chap7.html> (last visited Oct. 10, 2008). (“The US homeownership rate reached a record 69.2 percent in the second quarter of 2004. The number of homeowners in the United States reached 73.4 million, the most ever. And for the first time, the majority of minority Americans own their own homes.”).

13. A healthy economy and low interest rates helped push up real estate values across the country in the early 2000s. As values rose, the risk of default declined, since borrowers could tap home-equity lines of credit. That reduced risk appealed to lenders, which in turn offered loans to even more buyers, which added to the demand and further increased real estate prices. Vena Trehan, *The Mortgage Market: What Happened?*, NPR, Apr. 26, 2007. As prices skyrocketed, speculators entered the market, driving the cycle even further. *Id.* See also U.S. CENSUS BUREAU, CENSUS BUREAU DATA ON NEW HOME PRICES, <http://www.housingbubblebust.com/HsgData/CB/New/Sales/Prices.html>.

14. “America was awash in a stark, raving frenzy that looked every bit as crazy as dot-com stocks.” Eugenia Levenson, *Lowering the Boom? Speculators Gone Mild*, FORTUNE, Mar. 15, 2006; “I worry about a big fall because prices today are being supported by a speculative fever.” Maria Bartiromo, *Jitters on the Home Front*, BUS. WK., Mar. 6, 2006.

15. The White House, President George W. Bush, Fact Sheet: Dismantling the Barriers to Home Ownership, <http://www.whitehouse.gov/news/releases/2004/03/20040326-5.html> (last visited Oct. 10, 2008).

16. “[W]hen faced with the prospect of having to put off owning a home, buyers have been looking for any way to get in, especially when it means (they hope) a chance to ride the double-digit gains that homeowners have been racking up.” Cybele Weisser, *Crazy Loans: Is This How The Boom Ends?*, MONEY MAGAZINE, Sept. 16, 2005.

out secondary loans to make payments on their primary loans.¹⁷ Banks also offered teaser rates on adjustable rate mortgages¹⁸ and commonly included prepayment penalties.¹⁹

These tactics worked. Millions of Americans entered into adjustable rate mortgages (“ARMs”).²⁰ ARMs have been a staple of the mortgage industry for years, although borrowers traditionally balked when offered them.²¹ During the housing boom, the fear of missing an opportunity for wealth creation supplanted this prudence.

Americans proved open to other forms of creative financing, and lenders and buyers threw caution to the wind. For example, lenders offered piggyback loans,²² which enabled borrowers to purchase homes they could not afford.²³ It also became common for loan agents to counsel buyers into purchasing property without a down payment. Banks conducted little due diligence²⁴ and borrowers accepted preda-

17. “Don’t have the money to pay [the teaser]? . . . Take a home-equity loan against your new house to meet those minimal payments.” James J. Cramer, *Bloody and Bloodier*, N.Y. MAGAZINE, Aug. 13, 2007.

18. Adjustable rate mortgages (“ARMs”) “are loans whose interest rates adjust up or down periodically. The initial rate is typically fixed for a period of two or three years. The benefit is that the starter rates [in the first few years] are lower for ARMs than for traditional, fixed-rate mortgages.” Trehan, *supra* note 13.

19. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007.

20. “Nearly 25% of mortgages – 10 million – carry adjustable interest rates. And most of them went to people with subpar credit ratings who accepted higher interest rates.” Noelle Knox, *Some Homeowners Struggle*, USA TODAY, Apr. 3, 2006.

21. “With an ARM, the borrower, not the lender, shoulders the risk that inflation (and thus, interest rates) will kick up.” Ira Carnahan, *Mortgage Tricks*, FORBES, June 9, 2003. In theory, the risk should be diminished by economic norms: “if interest rates shoot up, inflation should adjust salaries up too.” *Id.* The truth, of course, is not so simple. See Nell Henderson, *Pay Lags Behind Inflation*, WASH. POST, July 30, 2005.

22. “Piggyback loans get their name from a second mortgage that is ‘piggybacked’ onto a first mortgage to compensate for buyers unable to come up with a larger down payment or any at all.” Broderick Perkins, *Piggyback Loan Growth Poses Mortgage System Risk*, REALTY TIMES, July 13, 2005.

23. “42 percent of home purchase mortgage loan dollars involved piggyback loans during the first half of 2004, more than double the level in 2001.” *Id.* Piggyback loans contribute to housing market bubbles, when used in excess to enable homebuyers to purchase homes they cannot afford. *Id.*

24. “In both 2006 and 2007, well over 40 percent of subprime borrowers were awarded mortgages with either little or no documentation of their ability to pay.” Les Christie, *Subprime loans defaulting even before resets*, CNN MONEY, Feb. 20, 2008, http://money.cnn.com/2008/02/20/real_estate/loans_failing_pre_resets/index.htm?postversion=200802201. “With these so-called ‘liar loans,’ borrowers did not have to show proof of either earnings or assets.” *Id.* “[S]mall down payments were combined with other risk factors, such as a lack of documentation of sufficient income to make the required loan payments.” Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Statement at the Independent Community Bankers of America Annual Convention, Orlando, Florida (Mar. 4, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm>).

tory loans.²⁵ Families and investors were drawn by the possibility of huge returns. Many lenders, however, had a different objective.

These lenders used a creative financing technique called asset securitization²⁶ to pool their mortgage loans, typically through an intermediary, and then issue securities representing claims on the principal and interest payments made by the borrowers on the loans in the pool.²⁷ However, not all debt is equal. The creditworthiness of the underlying obligor impacts the value of the debt, and the least creditworthy obligors received what are known as “subprime mortgages.”²⁸ As the lenders’ standards continued to fall, the amount of securitized mortgages backed by non-creditworthy borrowers rose.²⁹ Since the actual mortgages were secured by real estate, the lenders and debt-investors were insulated from risk so long as the real estate market continued to boom.³⁰ If borrowers defaulted on their loans, the assets securing those loans could be resold to recoup investors’ losses. Unfortunately, the sharp increase in housing prices is now understood as a massive price bubble.³¹ The bubble has burst.³²

25. “Predatory lending is rooted in deceptive and in some cases illegal practices to coerce borrowers into unfavorable mortgage agreements.” ROBERTO G. QUERCIA, MICHAEL A. STEGMAN & WALTER R. DAVIS, *THE IMPACT OF PREDATORY LOAN TERMS ON SUBPRIME FORECLOSURES: THE SPECIAL CASE OF PREPAYMENT PENALTIES AND BALLOON PAYMENTS 4* (Cir. for Cmty. Capitalism Kenan Inst. for Private Enter. Univ. of N. Carolina at Chapel Hill ed., 2005), available at <http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf>. Common features of predatory loans include, “lengthy and costly prepayment penalties that prevent borrowers from refinancing when interest rates fall.” *Id.*

26. Assets such as credit cards, automobile loans and home equity loans are packaged as the collateral for intermediate-term. . . securities and sold in the public markets or as private placements. . . . [T]hese securities now trade at interest-rate spreads over Treasury bills that make them a relatively low-cost source of funding for many companies.

Philip L. Zweig, *Asset-Backed Securities*, *THE CONCISE ENCYCLOPEDIA OF ECONOMICS* (2008).

27. Jeffrey A. Lenobel & Robert S. Nash, *Financing Demystified: How Mortgage-Backed Securities Are Assembled and Sold*, N.Y.L.J., Sept. 30, 1998.

28. “Subprime mortgages are extended to applicants deemed the least creditworthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risk and warrant the highest interest rates.” Danielle DiMartino & John v. Duca, *The Rise and Fall of Subprime Mortgages*, FEDERAL RESERVE BANK OF DALLAS, Vol. 2, No. 11, Nov. 2007.

29. “As late as 2003, subprime loans accounted for only 8.5 percent of the value of mortgages issued in this country. In 2005 and 2006, the peak years of the housing bubble, subprime was 20 percent of the total.” Krugman, *supra* note 2.

30. “The current subprime mortgage market was built on the belief that double digit gains in home appreciation would continue forever.” Patrick Madigan, *Overview of the Subprime Foreclosure Crisis 3* (2007), http://www.iowa.gov/government/ag/latest_news/releases/sept_2007/Foreclosure_analysis.pdf.

31. In economic terms, a “bubble” is trade in high volumes at prices that are considerably at variance from intrinsic values. Ronald R. King, et al., *The Robustness of Bubbles and Crashes in Experimental Stock Markets*, *NONLINEAR DYNAMICS AND EVOLUTIONARY ECONOMICS* (1993); “[The housing] boom is now the mother of all bubbles – in sheer volume, if not in degrees of

Mortgage delinquencies increased substantially in 2005,³³ with lenders initiating 641,000 foreclosures.³⁴ That number grew to almost 971,000 in 2006³⁵ and 1.5 million in 2007.³⁶ The majority of these foreclosures were subprime mortgages.³⁷ The mortgage holders found themselves far more exposed than they had anticipated³⁸ because much of the property securing the mortgages was worth less than the principal on the notes.³⁹ Meanwhile, ARMs are continuing to reset⁴⁰ at ever-higher rates,⁴¹ leading to fresh waves of defaults.⁴² Thus while the full impact of the price bubble burst may not be known for some time,⁴³ it has already wracked the world markets.⁴⁴ The fallout will cause the middle-class to suffer tremendously.⁴⁵

speculative madness." Ambrose Evans-Pritchard, *No Mercy Now, No Bail-out Later*, TELEGRAPH, Mar. 23, 2006.

32. "It's now conventional wisdom that a housing bubble has burst. . . . Housing peaked in 2005. By early 2006 it was widely recognized the boom was likely over, and by mid-2006 it was beyond question." Justin Lahart, *Egg Cracks Differ in Housing, Finance Shells*, WALL ST. J., Dec. 24, 2007.

33. Bernanke, *supra* note 24.

34. *Foreclosures Increase at 51 Percent Nationwide*, EAST BAY BUSINESS TIMES, Jan. 8, 2007, <http://eastbay.bizjournals.com/eastbay/stories/2007/01/08/daily8.html>.

35. *Id.*

36. Bernanke, *supra* note 24.

37. *Id.*

38. *Id.*

39. One national house price index, "which rose at close to a double-digit pace from 2000 through 2005, has slowed to show only small gains for the past several quarters, and some areas are seeing outright price declines." Governor Randall S. Kroszner, Remarks at the Consumer Bankers Association 2007 Fair Lending Conference, Washington, D.C. (Nov. 5, 2007) (transcript available at <http://www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm>).

40. "About \$460 billion worth of adjustable mortgages are scheduled to reset [throughout 2008], raising minimum payments for borrowers . . . About \$190 billion in subprime adjustable mortgages are slated to reset this year." Sharon L. Lynch, *U.S. Home Foreclosures Jump 90% as Mortgages Reset*, BLOOMBERG, Feb. 28, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=azx0LzcT19ao&refer=home>.

41. The Federal Reserve Board estimates that the interest rate on a typical subprime ARM slated to reset in Spring, 2008, will increase to about 9.25% from just above 8%, raising the monthly payment by more than 10%, to \$1,500 on average. Bernanke, *supra* note 24.

42. "Banks may be forced to resell as many as 1 million foreclosed properties this year, adding to a glut of inventory and forcing prices down even further." Lynch, *supra* note 40.

43. Already, the subprime mortgage crisis has caused financial losses in excess of \$300 billion. The figure will continue to rise sharply. Nouriel Roubini, *A Sobering 12-Step Scenario*, FIN. WK., Feb. 25, 2008.

44. *Id.*

45. Home prices are expected to fall between 20% and 30% from their peak, impacting the tens of millions of Americans who avoided investing in real estate during the boom. It is likely that the damage will spread from the residential markets to the commercial markets, adding additional strain to the regional and national banks that are heavily exposed to these mortgages. If bank losses grow, that would add to the recession and could lead to a wave of corporate defaults. *Id.*

Foreclosures follow the wave of defaults. “For communities, foreclosed homes frequently remain vacant for prolonged period of time [sic], during which they may be poorly maintained. Foreclosed homes are often a primary source of neighborhood instability in terms of depressed property values and increased crime.”⁴⁶ At a national level, the rise in foreclosures will add to the glut of unsold property, already at more than two million units, and further depress prices.⁴⁷

It is difficult to address the problems associated with subprime lending. Subprime lending is an important element of the financial system because it offers credit to high-risk borrowers who might otherwise be unable to obtain financing.⁴⁸ However, the subprime lending industry appears to be more susceptible to abusive lending practices than the prime market.⁴⁹

B. *The Promise and Problems of Prepayment Provisions*

For years, the mortgage industry has used teasers and adjustable rates to attract borrowers. Under traditional contract principles, these techniques likely withstand judicial scrutiny.⁵⁰ Prepayment provisions, however, often involve penalties intended to secure performance, and such penalty provisions are unenforceable under traditional contract law.⁵¹

Prepayment provisions are contractual terms permitting a mortgagor to pay the outstanding principal on a loan prior to the contractual

46. JOINT U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 51 (2000), <http://www.huduser.org/publications/pdf/treasrpt.pdf> (hereinafter “Task Force”).

47. Bernanke, *supra* note 24.

48. Task Force, *supra* note 46.

49. “A subprime borrower may have few financial options available or less information on loan terms and conditions and less opportunity to shop for the best terms and conditions available.” *Id.*

50. Under the fundamental principles of freedom of contract, parties have a broad right to enforce contractual provisions that are not unconscionable, illegal, or violative of public policy. SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS Vol. 24 § 65:1, at 213-15 (4th ed. 1993) (hereinafter “WILLISTON”). There is nothing *per se* illegal or unconscionable about introductory or variable rates. *Id.* But see Thomas J. Miller, Attorney General of Iowa, Opening Statement at the Board of Governors Federal Reserve System Public Hearing Pursuant to Section 158 of the Home Ownership and Equity Protection Act of 1994 (June 14, 2007) (transcript available at http://www.federalreserve.gov/SECRS/2007/August/20070823/OP-1288/OP-1288_96_1.pdf). (providing “[r]equiring lenders to stop underwriting loans based on the temporary and artificially low teaser rate will help consumers by encouraging sustainable homeownership.”)

51. “The central objective behind the system of contract remedies is compensatory, not punitive. Punishment of a promisor for having broken his promise has no justification on . . . economic grounds. . . and a term providing such a penalty is unenforceable on grounds of public policy.” WILLISTON, *supra* note 50, at 226.

date of maturity.⁵² The financial status of a mortgagor may change significantly during the life of his or her mortgage, and prepayment provisions provide mortgagors a way out of their loan. This can be advantageous for a number of reasons. For example, the mortgagor may come into money and wish to own his property outright. A mortgagor may need to refinance in the event of financial hardship or interest rates may fall, creating a strong incentive to refinance.⁵³ For mortgagees, prepayment creates an undesirable risk. The mortgagee has an interest in receiving the stream of interest payments on the outstanding principal.⁵⁴ Thus, mortgagees require the payment of some premium⁵⁵ in order for a mortgagor to prepay the principal.⁵⁶ In theory, prepayment provisions are mutually advantageous.⁵⁷ In practice, however, prepayment provisions are often abused. Of the mortgages created during the recent real estate boom, tens of millions contained prepayment provisions handcuffing the mortgagor to the loan through its date of maturity.⁵⁸

Prepayment provisions come in a variety of forms.⁵⁹ One form is a flat-fee clause.⁶⁰ A flat-fee clause fixes a number, either a dollar amount or a percentage of the loan balance, as the price of payment.⁶¹ Another prepayment form is a declining percentage clause, often

52. RESTATEMENT (THIRD) OF PROP.: (MORTGAGES) § 6.2 (1997).

53. If the mortgagor has the opportunity to refinance at a more attractive rate, the mortgagor may find it advantageous to prepay the existing debt, even if he must also pay a prepayment fee. *Id.* at 404.

54. This represents the mortgagee's expectancy interest. "The expectancy interest refers to the fulfillment of an aggrieved party's expectancy of gain if the bargain to which he was a party had been carried out and performed." JAMES M. FISCHER, UNDERSTANDING REMEDIES § 6.1, at 27 (2d ed. 2006).

55. "About 70 percent of subprime loans have costly prepayment penalties that trap borrowers . . . and . . . keep borrowers from shopping for a better deal." Geraldine Fabrikant, *A Home Loan Trap*, N.Y. TIMES, Sept. 13, 2007.

56. Prepayment need not always be in one lump sum. Mortgagees will often refer to a "prepayment risk." This risk can be defined as follows: "As prepayments occur, the amount of principal retained in the bond declines faster than what otherwise may be expected - thereby shortening the average life of the bond by returning principal." Fidelity Investments, *Mortgage-Backed Securities: Product Overview*, <http://personal.fidelity.com/products/fixedincome/pombs.shtml>.

57. The benefits to the lender are set out above. Lenders argue that the benefits to borrowers are lower monthly payments, as well as broader availability of loans. Fabrikant, *supra* note 55.

58. According to the Center for Responsible Lending, more than two-thirds of the adjustable rate loans carried prepayment penalties. *Id.* Unsurprisingly, those loans also carried low teaser interest rates, which rose sharply over time. *Id.*

59. Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 869-71 (1993).

60. *Id.* at 870.

61. *Id.*

found in commercial mortgages,⁶² which permits prepayment if the borrower pays a fee defined as a declining percentage of the loan balance over time.⁶³ A declining percentage clause often prohibits prepayment for a limited period of time.⁶⁴ A third form of prepayment involves a yield-maintenance clause,⁶⁵ which attempts to measure, or at least approximate, a lender's actual damage flowing from prepayment.⁶⁶ A rudimentary yield-maintenance clause might fix a fee as the difference between the loan interest rate and the then-current yield on U.S. Treasury notes closest in maturity to the remaining loan term, multiplied by the loan balance and then by the number of years remaining on the loan term.⁶⁷

It can be difficult for courts to determine when a provision is valid and when it is a penalty.⁶⁸ In 2006, the Northern District of Illinois crafted an intelligible test for prepayment provisions seeking to separate the enforceable from the unenforceable.⁶⁹ The court's analysis was grounded in contract principles and affected all lending practices in the state of Illinois.⁷⁰

This paper: (1) considers the theoretical and legal underpinnings of prepayment provisions; (2) analyzes the Northern District decision and legacy; and (3) contemplates the future of prepayment provisions.

62. *Id.*

63. *Id.*

64. Whitman, *supra* note 59, at 870-71.

65. *Id.* at 871. They are called "yield maintenance" because they are designed to give the lender the economic equivalent of the yield it would have earned if the loan had remained in place for its full term. *Id.*

66. "Yield maintenance formulas are calculated to cover the lender's reinvestment loss when prepaid loans bear above-market rates." George Lefcoe, *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment*, 28 REAL EST. L.J. 202 (2000).

67. Whitman, *supra* note 59, at 871.

68. "A subtle distinction, not always observed, exists between clauses that merely induce performance and those that operate coercively; and the failure to observe it . . . will result in the invalidation of clauses that ought . . . to be enforced." WILLISTON, *supra* note 50, at 2.

69. River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co., No. 03-C-4354, 2006 WL 2787483 (N.D. Ill. Sept. 22, 2006).

70. *Id.*

III. THE LAW OF PREPAYMENT

The general rule, both in Illinois⁷¹ and nationally,⁷² is that borrowers do not have an absolute right to prepay a loan.⁷³ Nevertheless, borrowers often insist upon the inclusion of prepayment provisions in their lending agreements.⁷⁴ The nation's largest residential lenders prioritize the inclusion of these provisions in all loans issued.⁷⁵

Prepayment provisions either make refinancing impossible to obtain for many mortgagors⁷⁶ or offset the financial benefit that would otherwise accrue to the mortgagor from refinancing.⁷⁷ Recognizing the potential abuse of prepayment provisions, the Illinois legislature enacted the Illinois Interest Act⁷⁸ to provide a modicum of protection to certain residential mortgagors. However, the Interest Act only prohibits prepayment penalties for residential mortgages in which the rate of interest exceeds eight percent per annum.⁷⁹ The efficacy of the Interest Act is rather limited when interest rates are at or near historic lows. Thus in an age of record-low interest rates,⁸⁰ the Act's protections might generously be described as paltry.

71. It is settled law in Illinois that a borrower has no absolute right to prepay a loan. *Latimer v. Grundy County Nat'l Bank*, 239 Ill. App. 3d 1000, 1001 (3d Dist. 1993).

72. "At common law . . . the mortgagor may not exercise his or her right to redemption before maturity. Thus, in the absence of a prepayment clause, a mortgagor generally has no right to insist that the mortgagee accept payment prior to the date of maturity." 55 AM. JUR. 2D *Mortgages* § 345 (2006).

73. [T]he majority rule in this country is, and for a long time has been, that, absent special agreement, the mortgagor in an unregulated transaction who promises to repay the loan, in installments at specified times or at a specified date, does not have a right to compel the creditor to accept prepayment.

Promenade Towers Mut. Hous. Corp. v. Metro. Life Ins. Co., 587 A.2d 1377, 1379 (Md. 1991).

74. Commercial borrowers, in particular, place an emphasis upon the inclusion of such provisions – no surprise perhaps, given that many such borrowers are relatively sophisticated and have the advice of counsel. Yet these sophisticated borrowers often find themselves in a situation similar to residential borrowers. It may be that commercial lenders, given their greater access to resources and lobbyists, will be the ones to bring pressure upon Congress to reform the lending industry.

75. Countrywide Financial Corporation created incentives for its sales force to include such provisions. According to one mortgage sales representative affiliated with Countrywide, "adding a three-year prepayment penalty to a loan would generate an extra 1 percent of the loan's value in a commission." Morgenson, *supra* note 19.

76. According to the Acorn Financial Justice Center, lenders refer to the practice of including prepayment provisions in their loans as "closing the back door" by making it too costly for borrowers to get out of loans with rising rates. Fabrikant, *supra* note 55.

77. *Id.*

78. 815 ILCS 205/4(2)(a) (West 2007).

79. *Id.*

80. For instance, in January 2008, the average rate for a fixed-rate 30-year mortgage was 5.68%. Sandra Block, *Low Mortgage Rates Make Refinancing Attractive*, USA TODAY, Feb. 2, 2008, available at, http://www.usatoday.com/money/perfi/columnist/block/2008-02-04-refinancing_N.htm.

The issues raised by subprime loans and prepayment provisions are closely intertwined.⁸¹ Prepayment provisions are distinct characteristics of subprime loans.⁸² Over the past decade, the percentage of subprime loans with prepayment provisions increased from fifty to seventy percent.⁸³ In the prime market, by contrast, only about two percent of home loans carried similar prepayment provisions.⁸⁴ As a practical matter, prepayment provisions extend the average life of a mortgage.⁸⁵ For an average subprime loan, a prepayment provision reduces the rate of prepayment by roughly ten percent over the life of the prepayment term.⁸⁶

Congress has belatedly grasped the extent of the problem. According to the Joint Economic Committee,⁸⁷ nearly two million subprime borrowers will lose their homes to foreclosure before the end of 2009, at an estimated cost of roughly seventy-one billion dollars in housing wealth.⁸⁸ Yet some of this loss could be mitigated if homeowners had the opportunity to refinance their mortgages, an opportunity often foreclosed by prepayment provisions.⁸⁹ While the judiciary has the power to provide homeowners with relief from prepayment penalties, Congress can provide a uniform solution.

81. Quercia, *supra* note 27, at 7.

82. *Id.*

83. *A Snapshot of the Subprime Market*, THE CENTER FOR RESPONSIBLE LEARNING, NOV. 27, 2007, <http://www.responsiblelending.org/issues/mortgage/quick-references/a-snapshot-of-the-subprime.html>.

84. *Id.*

85. According to the Center for Community Capitalism:

Prepayment penalties . . . slow down the repayment of the outstanding principal, increasing the likelihood that borrowers may experience negative equity in the event of a downturn in the market. In addition, prepayment penalties can reduce the refinancing and other choices available to borrowers when confronted with a crisis, or of refinancing into a lower cost prime loan as a result of improving their credit record, making the option to default more desirable.

QUERCIA, *supra* note 25, at 8.

86. QUERCIA, *supra* note 25, at 7.

87. "The Joint Economic Committee is a bicameral Congressional Committee composed of ten members from each the Senate and the House of Representatives. . . . Its main purpose is to make a continuing study of matters relating to the US economy. The committee holds hearings, performs research and advises members of Congress." *Committee Background*, U.S. CONGRESS: JOINT ECONOMIC COMMITTEE, <http://jec.senate.gov/index.cfm?FuseAction=About.Committee.Background>.

88. Bloomberg, *Subprime Crisis Toll Tabbed at \$71 Billion*, BOSTON GLOBE, Oct. 26, 2007, available at, http://www.boston.com/realestate/news/articles/2007/10/26/subprime_crisis_toll_tabbed_at_71b/.

89. According to Senator Christopher J. Dodd, "About 70% of subprime loans have costly prepayment penalties that trap borrowers in high-cost mortgages, mortgages that strip wealth rather than build it." Fabrikant, *supra* note 55.

Whatever response Congress crafts, it will inevitably leave some unhappy. Despite the abusive lending practices during the real estate boom, Congress should think twice before banning *all* prepayment provisions. The societal costs of prepayment provisions are great, but the costs associated with the outright removal of *all* prepayment provisions might be even greater.⁹⁰ Prepayment provisions, at least in theory, help ensure a robust lending industry by protecting both borrowers and lenders from interest rate fluctuations. Moreover, lenders need some margin to cover their losses or the cost of borrowing will continue to rise.

Prepayment may . . . result in further losses [to the lender], such as the administrative and legal costs of making a new loan . . . , and in some cases additional tax liability. Moreover, the mortgagee may be forced to place the prepaid funds temporarily in a relatively low-yielding short-term investment while awaiting another suitable mortgage-lending opportunity.⁹¹

As one court explained the problem:

The lender has committed itself to leave its funds outstanding for a fixed period at a given interest yield, and to suffer the market rate risk inherent in this position . . . From the lender's viewpoint, a prepayment is a derogation of the right to earn the agreed yield for the full term even if extrinsic rates drop. In other words, the borrower breaches its obligation to keep the loan in effect for its full term.⁹²

The problem is not the existence of prepayment provisions. Rather, the problem is the lending industry's use of abusive provisions, which are intended only to secure performance.

Until the federal government acts, the task of sorting out which prepayment provisions should be enforced falls on the courts and state legislatures.

IV. SOCIAL UTILITY AND UNCERTAINTY

Courts have traditionally recognized that bargained-for prepayment provisions serve legitimate business purposes and generally should be enforced.⁹³ The courts should not provide equitable relief from all

90. "Even when prepayment penalties are present, most borrowers can still prepay up to 20 percent of the original loan amount in any 12-month period without incurring penalties." QUERCIA, *supra* note 25, at 7 n.8.

91. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 (1997).

92. Whitman, *supra* note 59, at 871-72.

93. *W. Raleigh Group v. Mass. Mut. Life Ins. Co.*, 809 F. Supp. 384, 388 (E.D.N.C. 1992). See also *Prentice v. UDC Advisory Servs., Inc.*, 648 N.E.2d 146, 153 (Ill. App. Ct. 1995) (finding that "the sanctity of a promise, certainty in the marketplace and the expectation of parties, are cornerstones of contract law."); *Delcon Group, Inc. v. N. Trust Corp.*, 543 N.E.2d 595, 605 (Ill. App.

prepayment provisions,⁹⁴ only those that operate as de facto penalties. Lenders cannot predict with absolute certainty whether future interest rates will rise or fall. With every mortgage loan comes the risk of prepayment and consequent loss of yield.⁹⁵ Prepayment fees shift the risk of loss associated with prepayment from the mortgagor to the mortgagee. In substance, the clause compels a mortgagee to bear that loss, however great it may be, in return for the receipt of the fee stated in the clause.⁹⁶

However, prepayment penalties may also bestow benefits upon borrowers as well as lenders. According to Kurt Pfothenauer, senior vice-president for government affairs at the Mortgage Bankers Association (“MBA”), “You want to give pause before banning prepayment penalties. . . . They save consumers’ money by lowering their rates.”⁹⁷ The MBA supports a three-year limitation on prepayment penalties for all mortgages.⁹⁸ A more significant restriction or outright prohibition on prepayment penalties could increase rates to borrowers and eliminate some financing options for consumers.⁹⁹

A developing body of literature argues the deference traditionally paid to prepayment penalties was misplaced.¹⁰⁰ The Center for Responsible Lending recently concluded “prepayment penalties resulted in no statistically [significant] differences in interest rates.”¹⁰¹ This

Ct. 1989) (finding that “a party to a contract has a certain and enforceable expectation of receiving the benefits of the contract.”).

94. “A freely-bargained prepayment fee clause ought to be enforced against the borrower who makes a voluntary prepayment, irrespective of the amount of money that the lender’s clause demands.” Whitman, *supra* note 59, at 890.

95. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 (1997).

96. *Id.*

97. Fabrikant, *supra* note 57.

98. *MBA Encourages Federal Reserve To Use HOEPA Authority “Surgically And In A Targeted Manner,”* MORTGAGE BANKERS ASSOCIATION, Aug. 15, 2007, <http://www.mortgagebankers.org/NewsandMedia/PressCenter/56183.htm>. The MBA also expects that the market will conform to the recent subprime statement requiring prepayment penalties not extend beyond the reset period of hybrid ARMs and allow borrowers a period of up to sixty days prior to the initial ARM reset to avoid a prepayment penalty. *Id.*

99. Peter G. Miller, *How To End Lethal Prepayment Penalties*, REALTYTRAC, Oct. 11, 2007.

100. According to Senator Christopher J. Dodd:

Prepayment penalties unfairly trap subprime borrowers in expensive subprime mortgages. These penalties make it cost-prohibitive to refinance into better loans, or strip out equity when the penalty is paid. Studies . . . show that interest rates on subprime loans are no lower for loans with prepayment penalties – the ostensible rationale for these fees – than for loans without these penalties.

Dodd Introduces Legislation to Protect American Homeownership, CHRIS DODD UNITED STATES SENATOR FOR CONNECTICUT, Dec. 12, 2007, <http://dodd.senate.gov/index.php?qN%de/4167>.

101. Federal Reserve Board, *Comments on Proposed Interagency Statement on Subprime Mortgage Lending*, CENTER FOR RESPONSIBLE LENDING, May 7, 2007, <http://www.responsiblelending.org/policy/regulators/comments.html>.

finding stands in stark contrast to the justification commonly offered for prepayment penalties.

Lenders often claim prepayment penalties are irrelevant for borrowers with hybrid ARMs because the penalties typically remain in effect only for the duration of the teaser rate period.¹⁰² This, however, puts borrowers in the perverse situation of choosing to refinance prior to reset—when their current rates are as low as they will ever be—and incurring a prepayment fee or defaulting on the post-reset payment.¹⁰³

Removing prepayment provisions altogether would decrease activity in the secondary debt market,¹⁰⁴ impacting the willingness and ability of lenders to engage in high-volume lending.¹⁰⁵ The Department of the Treasury has expressed concern about this inhibition.¹⁰⁶

While prepayment provisions are generally enforceable, exceptions exist for unconscionable clauses and those violating the duty of good faith and fair dealing. However, demonstrating a clause is unconscionable is complicated. For instance, courts routinely enforce prepayment provisions calling for “extremely large fee[s],”¹⁰⁷ treating such fees as the functional equivalent of lock-in clauses.¹⁰⁸ Courts routinely enforce lock-in clauses which prohibit prepayment entirely.¹⁰⁹

Some courts have subjected prepayment provisions to a liquidated damages analysis.¹¹⁰ A liquidated damages clause sets, or liquidates, damages at a particular amount.¹¹¹ Parties use such clauses to deter-

102. *Id.*

103. *Id.*

104. *Id.* While the unbridled securitization of debt and issuance on the public markets caused the current crisis, any decision that would impact the value of the securities should be taken into consideration, notwithstanding the current realities of the marketplace.

105. Mortgage companies introduced prepayment penalties on mortgage loans to satiate the concerns of the investors purchasing securities on the secondary mortgage market. Since prepayment penalties assure the investor some compensation if the loan is paid off early, investors are willing to accept lower returns on their investment. David C. Dopp, *Some Other Things You Should Know About Prepayment Penalties*, INTEREST.COM, 2003 http://mortgages.interest.com/content/firsttime/pers_dd1.asp.

106. “Significant restrictions or prohibitions of such penalties in the high-cost loan market could serve to inhibit the flow of credit to these borrowers, at least temporarily, by forcing the secondary market to retool its securitization strategies” Task Force, *supra* note 46, at 95.

107. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 (1997).

108. *Id.*

109. *Id.*

110. The reason many courts analyzing prepayment provisions apply a liquidated damages analysis might be that liquidated damages are often only effectuated by a breach, which, in and of itself becomes the subject of litigation; and an analysis of the reasonableness of a supposed ‘liquidated damages’ clause takes courts down a less-convoluted path than that presented by alternatives.

111. David S. Steuer, *Drafting Corporate Agreements 2008: A Litigator’s Perspective on the Drafting of Commercial Contracts*, 1642 PLI/CORP 353, 365 (2008).

mine the damage amount due in the event of a breach.¹¹² There is only a smattering of Illinois case law addressing prepayment provisions.¹¹³ The Illinois Supreme Court has not established when a prepayment provision ought to be enforced or the circumstances, if any, in which voluntary prepayment provisions should be treated as liquidated damages.¹¹⁴

The law of liquidated damages is substantially more developed than the law of prepayment provisions. There are clear rules governing when a court should find such provisions unenforceable.¹¹⁵ Under Illinois law, a liquidated damages provision will be enforced if it meets the test set out in the Restatement (Second) of Contracts.¹¹⁶ Illinois courts look at the following three elements to determine whether the provisions meet the Restatement test:

- (1) the parties [must have] intended to agree in advance to the settlement of damages that might arise from the breach; (2) the amount of liquidated damages was reasonable at the time of contracting, bearing some relation to the damages which might be sustained; and (3) actual damages would be uncertain in amount and difficult to prove.¹¹⁷

Furthermore, it is well-settled in Illinois that reasonable liquidated damages provisions are enforceable, while terms fixing unreasonably large liquidated damages awards are unreasonable.¹¹⁸ Courts will look to the substance of an agreement to determine whether the parties wrapped a penalty in the cloth of liquidated damages.¹¹⁹ When determining whether actual damages would be uncertain in amount and difficult to prove, courts look at the circumstances surrounding the

112. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981).

113. *In re AE Hotel Venture*, 321 B.R. 209, 219 (Bankr. N.D. Ill. 2005).

114. *River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, No. 03-C-4354, 2006 WL 2787483, at *1 (N.D. Ill. Sept. 22, 2006).

115. *Jameson Realty Group v. Kostiner*, 813 N.E.2d 1124, 1130 (Ill. App. Ct. 2004).

116. *Id.* (“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.” (quoting RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981))).

117. *Jameson Realty Group*, 813 N.E.2d at 1130 (quoting *Med+Plus Neck & Back Pain Ctr., S.C. v. Noffsinger*, 726 N.E.2d 687 (Ill. App. Ct. 2000)).

118. *Id.*

119. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. c (1981) (“Neither the parties’ actual intent as to its validity nor the characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid. Sometimes parties attempt to disguise a provision for a penalty. . . . [A] court will look to the substance of the agreement to determine whether this is the case or whether the parties have attempted to disguise a provision for a penalty that is unenforceable under this Section.”).

agreement.¹²⁰ Additionally, the provision must specify the breach and the consequent amount of damages; it may not serve merely as a threat or a means to punish nonperformance.¹²¹

Prepayment provisions are analogous to liquidated damages provisions. When courts consider whether to enforce a liquidated damages provision, they look first to whether the parties agreed in advance to a settlement of damages. This element is present in all prepayment provisions.¹²² Courts next consider whether the provision bears any relation to the actual damages that might be sustained. This element is also present in all prepayment provisions.¹²³ Finally, courts consider the degree of difficulty and uncertainty in calculating the actual amount of damages at the time of contracting. This difficulty and uncertainty is one of the primary reasons that lenders insist upon prepayment fees. Actual damages are both difficult and costly to calculate.¹²⁴ The test for whether to enforce liquidated damages provisions applies aptly to prepayment provisions.

V. A FEDERAL COURT TAKES A STAND

The Northern District of Illinois recently declared a prepayment provision unenforceable.¹²⁵ The case arose out of a 1999 commercial loan between the Variable Life Insurance Company (“VALIC”) and

120. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (1981) (“[T]he amount fixed is reasonable to the extent that it approximates the loss anticipated at the time of making the contract, even though it may not approximate the actual loss The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty . . . , the easier it is to show that the amount fixed is reasonable A determination whether the amount fixed is a penalty turns on a combination of these two factors. If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof is slight, less latitude is allowed in that approximation.”).

121. *Jameson Realty Group*, 813 N.E.2d at 1131 (citing *Med+Plus Neck & Back Pain Center, S.C. v. Noffsinger*, 726 N.E.2d 687, 693 (Ill. App. Ct. 2000)).

122. *Whitman*, *supra* note 61, at 860 (“Both lender and borrower recognize at the time of contracting that in the event the borrower pays the loan prior to maturity, the lender may suffer damage as a consequence.”).

123. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 cmt. c (1997) (“Since the amount of the loss depends largely on the movement of interest rates and cannot be predicted in advance of the actual prepayment, the amount of the fee may, as with other forms of insurance, be greater or smaller than the actual loss. The fee clause may also be viewed as *analogous to a liquidation of damages*.”) (emphasis added).

124. *Whitman*, *supra* note 59, at 873 (“[T]he core of the damage that lenders suffer from prepayment – the loss of an advantageous interest rate – is easy to measure. But the peripheral elements, such as the cost of relending the funds and the impact on the lender’s tax liability, may be much more difficult to assess. Only after an expensive and time-consuming trial can a jury be expected to determine these damages.”).

125. *River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, No. 03-C-4354, 2006 WL 2787483, at *12 (N.D. Ill. Sept. 22, 2006).

the predecessor of River East Plaza, L.L.C. (“River East”).¹²⁶ The loan was in the form of a first mortgage, in the amount of \$12.7 million with a twenty-year term, twenty-five year amortization, and a fixed interest rate of 8.02%.¹²⁷ The loan agreement, which VALIC drafted, included a prepayment provision. The relevant portion of the provision stated the amount due at prepayment was the greater of an amount calculated as set forth in paragraphs (1) or (2) (as applicable), below:

(1) at the time of receipt by [Defendant] of the Notice, the difference between (a) the then present value of all unpaid installments of principal and interest due and payable under this Note, calculated from the date of the proposed prepayment to the Maturity Date, discounted at the “Reinvestment Rate” (as hereinafter defined) and (b) the outstanding principal balance under this Note on the date of the proposed prepayment; or

(2) One percent (1%) of the then outstanding principal balance of the Note.

As used in this Note, “Reinvestment Rate” shall be the yield to maturity on a United States Treasury bond or note (the choice of which security to be used for such purposes being in the sole discretion of [Defendant]) having a maturity date of January 2, 2020 (or the maturity date closest thereto if no such bond or note has a maturity date of January 2, 2020).¹²⁸

According to the court, the prepayment provision represented the present value of: “(1) the interest income from the remaining principal VALIC would have received under the Loan rate for the remainder of the Loan (2) minus the interest income VALIC would obtain if the remaining principal [was] invested at the reinvestment rate for the remainder of the Loan’s term.”¹²⁹ VALIC included an identical provision in all of its loan documents.¹³⁰ The purpose of the provision was to make the lender whole on a similar investment: The borrower paid the interest spread between the current loan rate and the yield on a Treasury note, so “the lender [was] financially ‘indifferent’ to being

126. *Id.* at *1.

127. *Id.* at *2.

128. *Id.* at *2-3.

129. *Id.* at *9 (“In other words, the prepayment provision should represent the present value of the lost interest on the remaining principal over the term of the Loan if VALIC reinvested the principal in a comparable investment at the reinvestment rate.”).

130. *Id.* at *3 (“VALIC’s loan officer was unaware of any instance in which a borrower was able to negotiate a change in the provision in 1999. . . . [T]wenty other VALIC notes from 1999 contained identical prepayment provisions.”).

prepaid.”¹³¹ As a practical matter, the borrower’s prepayment fee increased as the yield on the Treasury note decreased. During negotiations, River East questioned the enforceability of the provision.¹³² The week before River East executed the contract, the attorney for River East issued a letter expressing “no opinion” as to the enforceability of the provision.¹³³

In 2003, River East sold the mortgaged property but remained liable for the mortgage.¹³⁴ Later that year, River East filed suit in the Circuit Court of Cook County, seeking a declaratory judgment that the prepayment clause was unenforceable as a matter of law.¹³⁵ VALIC removed the action to the Northern District of Illinois, Eastern Division, based on the diversity of jurisdiction between the parties.¹³⁶ Because the District Court was sitting in diversity, it had to apply state law in a manner consistent with the state courts and in accord with the reasoning of the Illinois Supreme Court.¹³⁷

The issue before the court was whether the yield-maintenance clause was enforceable.¹³⁸ River East claimed the clause was a penalty punishing early payment and therefore unenforceable as a matter of law.¹³⁹ Specifically, River East argued the lender was overcompensated because the reinvestment rate was based solely upon a Treasury note with a maturity date similar to the loan.¹⁴⁰ River East maintained that VALIC should have added a basis point spread¹⁴¹ to the treasury rate.¹⁴²

131. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *6 (“[T]his is achieved by the borrower paying to the lender the interest spread between the current loan rate and the new investment vehicle chosen by the lender . . .”).

132. *Id.* at *3 (VALIC responded that the prepayment provision was part of their “form” document and was non-negotiable).

133. *Id.* (When questioned, counsel for plaintiff informed defendant that she could not provide a positive opinion as to the enforceability of the prepayment provision.).

134. *Id.* at *5.

135. *Id.*

136. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *5; 28 U.S.C. § 1332 (2007).

137. A federal court sitting in diversity applies the substantive law of the state in which the district resides. *Erie R.R. v. Tompkins*, 304 U.S. 64, 78 (1938).

138. *River E Plaza, L.L.C.*, 2006 WL 2787483 at *1.

139. *Id.* at *5.

140. *Id.* at *10.

141. An interest rate spread refers to the “number of basis points over a base rate index; the difference between the rate at which money can be borrowed and the rate at which it is loaned.” Principle Commercial Corp. Glossary of Terms, <http://www.principlecommercial.com/Glossary.aspx#I> (last visited July 27, 2008).

142. *River E. Plaza, L.L.C.*, 2006 WL 2787483 at *10 (stating that the plaintiff contended that without a spread, the yield-maintenance clause made defendant more than whole, for reasons explained in greater detail below).

The court made the critical determination that the law of liquidated damages¹⁴³ governed the analysis of prepayment provisions.¹⁴⁴ This determination framed the court's entire analysis. Pursuant to liquidated damages law, a prepayment provision is enforceable when it meets the following requirements, set out in *Jameson Realty Group*:

(1) [T]he amount of damages was reasonable at the time of contracting in that they bear some relation to the damages which might have been sustained; (2) the amount of actual damages from a breach would be uncertain and difficult to prove at the time of contracting; and (3) the parties intended to agree in advance to the settlement of damages that might arise from a breach.¹⁴⁵

The court determined the prepayment provision did not satisfy the *Jameson* criteria because the yield-maintenance clause was unreasonable at the time of contracting and did not bear some relation to the damages which might have been sustained.¹⁴⁶

The court accepted River East's argument that the yield-maintenance clause was unreasonable because it was based upon a nearly risk-free investment: a Treasury note.¹⁴⁷ In the commercial loan, VALIC had accepted the risk of debtor non-payment as part of the bargain.¹⁴⁸ If the yield-maintenance was enforceable, VALIC could

143. See WILLISTON, *supra* note 50, 65:1 (providing "[i]t is generally agreed that a liquidated damages provision does not violate public policy when, at the time the parties enter into the contract containing the clause, the circumstances are such that the actual damages likely to flow from a subsequent breach would be difficult for the parties to estimate or for the nonbreaching party to prove, and the sum agreed upon is designed merely to compensate the nonbreacher for the other party's failure to perform. On the other hand, a liquidated damages provision will be held to violate public policy, and hence will not be enforced, when it is intended to punish, or has the effect of punishing, a party for breaching the contract, or when there is a large disparity between the amount payable under the provision and the actual damages likely to be caused by a breach, so that it in effect seeks to coerce performance of the underlying agreement by penalizing non-performance and making a breach prohibitively and unreasonably costly.") (emphasis added).

144. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *8.

145. *Id.*

146. *Id.* at *12.

147. "[T]he prevailing interest rate on a Treasury security will always be lower than the prevailing rate on a commercial real estate loan because of the difference in risk of the latter." *Id.* See also Financial Web U.S. Treasury Securities, <http://www.finweb.com/investing/us-treasury-securities.html> (last visited July 21, 2007), which states:

United States Treasury Securities, also known as Treasuries, are fixed-income security instruments issued by the U.S. Treasury. . . . Most investors regard U.S. Treasury Securities as one of the safest investment vehicles in the world. This is because they're backed by the full faith and credit of the United States government, which is considered an excellent credit risk due to the size and diverse nature of the U.S. economy and the stability of the U.S. political system.

148. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *10. See also ENCYCLOPEDIA OF BUSINESS 301 (Jane A. Malonis ed., Gale Group 2d ed. 2000), which states:

In granting loans, the bank must balance the benefit of the additional interest income generated against the cost of a default on the loan. To estimate the probability that a

have received interest *without any risk* by reinvesting the principal and the prepayment fee in treasuries.¹⁴⁹ Alternatively, VALIC could have received an even greater return by reinvesting the principal and the prepayment fee in a comparable commercial real estate loan.¹⁵⁰ Either way, VALIC would receive a windfall.¹⁵¹ Following a bench trial, Judge Harrah entered judgment in favor of River East, and reduced the prepayment fee from \$3,885,679.00 to \$123,012.15.¹⁵²

The court also agreed with River East that VALIC should have applied a “spread” of interest points to the Treasury note rate to reflect the additional risk associated with mortgages.¹⁵³ The court calculated this spread by subtracting the Treasury note rate at the inception of the loan (6.75%) from the interest rate on the loan (8.02%).¹⁵⁴ This difference came out to 127 basis points, or 1.27%.¹⁵⁵ This total represented the risk differential: At the time of the loan, the difference between investing in the commercial loan and in a lower-risk treasury note was 127 basis points.¹⁵⁶ According to the court, VALIC should have added this risk differential to the Treasury note rate when calculating the amount owed under the prepayment provision.¹⁵⁷ Under this adjusted rate, VALIC would neither suffer a loss from prepay-

borrower will pay, banks gather information on their potential customers. . . . Banks often use credit scoring models that predict future payment performance. . . .

149. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *10. See also Seth Lubove & Elizabeth Stanton, *Pimco Power in Treasuries*, BLOOMBERG.COM, Feb. 20, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sidaYxf.yAPdYcc&refer=home> (“Investors view Treasuries as among the world’s safest and most liquid investments.”).

150. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *10.

151. “VALIC does not explain why a loan spread could not have been calculated . . . to insure that, while VALIC would not suffer a loss from prepayment, VALIC did not receive a windfall as here.” *Id.*

152. “Because the yield-maintenance clause of the prepayment provision is an unenforceable penalty, the prepayment provision’s second clause . . . providing a prepayment charge of 1% of the remaining principal on the loan, determines the prepayment fee.” *Id.* at *12.

153. See *id.* (“liquidated damages clause is most likely not a reasonable attempt to estimate the actual damages if the amount of damages is unchanging to the gravity of the breach”).

154. *Id.* at *6.

155. *Id.*

156. “This is the amount . . . that would be added to the rate at [the date of the loan’s inception] to make VALIC financially ‘indifferent’ to the proposed prepayment because VALIC would be fully compensated as though the loan had been paid over the entire term.” *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *6.

157. According to the Northern District of Illinois:

The use of Treasuries as the reinvestment rate can overcompensate a lender if it does not have a differential added because the lender can purchase a Treasury without the risk present in the CREM [(Commercial Real Estate Mortgage)] loan because a Treasury security is backed by the United States Government. A CREM loan compensates the lender for taking the comparatively higher risks of default and impairment to collateral by receiving a premium interest rate. Therefore, the prevailing interest rate on a CREM loan is higher than the interest rate paid on a Treasury security with the same

ment, nor receive a windfall.¹⁵⁸ This adjusted rate would also diminish the borrower's exposure in the event the Treasury note fell significantly between the time of the loan's execution and the notice of prepayment, as it had in the instant case.¹⁵⁹

Several other factors influenced the court's decision. When deposed, an officer at VALIC's parent company described the prepayment provision as "very, very punitive."¹⁶⁰ The court cited this testimony in support of its finding that the provision was an unenforceable penalty, designed primarily to punish nonperformance.¹⁶¹ The court determined that VALIC, at all relevant times, could have reinvested the prepaid funds in a comparable-risk investment within one day of River East's notice of intent to prepay or of actual receipt of the prepaid funds.¹⁶² VALIC had sufficient funds to make any type of a thirteen million dollar investment.¹⁶³ Since VALIC could otherwise mitigate its losses, the court presumably considered this as evidence that the prepayment provision was unreasonable.¹⁶⁴

In support of its holding, the court cited several cases from other jurisdictions,¹⁶⁵ which held that if a prepayment provision was disproportionate and did not bear a reasonable relation to the probable damages, then the provision was a penalty and invalid.¹⁶⁶ In the cited cases, the courts found the use of a treasury-based reinvestment rate without adding an additional spread of points constituted an impermissible penalty.¹⁶⁷

VI. THE SEVENTH CIRCUIT RESTORES THE STATUS QUO

VALIC promptly appealed the decision of the District Court to the Seventh Circuit. The Seventh Circuit's opinion begins by noting the

maturity date. VALIC's average real estate loan was 132 basis points over the average Treasury bill rate. . . .

Id.

158. *Id.*

159. See *River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, 498 F.3d 718, 721 (7th Cir. 2007).

160. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *12.

161. *Id.* at *12 n.6 ("An adverse inference is drawn from VALIC's failure to call [the officer] as a witness at trial to explain his prior testimony. . . .").

162. *Id.* at *7.

163. *Id.*

164. "[A] plaintiff's failure to mitigate, when mitigation is reasonable and would operate to reduce the plaintiff's loss, will result in a dollar for dollar reduction in the recovery by the amount not mitigated." FISCHER, *supra* note 54, at § 13.2.

165. *River E. Plaza, L.L.C.*, 2006 WL 2787483, at *10 (*citing In re Kroh Bros. Dev. Corp.*, 88 B.R. 997 (W.D. Mo. 1988)); *In re Skyler Ridge*, 80 B.R. 500 (C.D. Cal. 1987)).

166. *Id.*

167. *Id.*

Illinois Supreme Court has not adopted a test for determining when a prepayment fee amounts to a penalty.¹⁶⁸ Nevertheless, the Seventh Circuit applied a liquidated damages analysis to the prepayment provision.¹⁶⁹ However, the court first considered the “relative value of any alternatives.”¹⁷⁰ At the time River East prepaid its loan, the note had nearly thirteen million dollars in remaining interest obligations.¹⁷¹ The prepayment provision required River East to pay only \$3.9 million of that outstanding interest.¹⁷² With this finding, the court promptly concluded the provision had not been inserted into the loan for the “sole purpose of securing performance of the contract.”¹⁷³ The court never explained the significance of this finding; presumably, the court considered the prepayment as less of an expenditure of \$3.9 million than as a savings of \$9.1 million.

The court’s hesitancy to disrupt the status quo is apparent throughout the opinion. The court noted the sophistication of the parties and reiterated the traditional contract rule that parties have the freedom to contract however they wish.¹⁷⁴ The court recognized that although VALIC had contracted to receive \$16.4 million in interest over the course of twenty years, most of that interest was front-loaded into the first ten years of the loan.¹⁷⁵ VALIC received \$3.45 million between the first and third years of the loan, and an additional \$3.9 million during the fourth year.¹⁷⁶ In addition to the return of the entire principal, VALIC received some \$7.35 million in interest and prepayment fees. Thus, VALIC received roughly twenty million dollars of unrestricted funds in the four years following the initial loan.

VALIC could have immediately reinvested this money into either risk-free federal treasuries or a comparable commercial loan, two options which offered VALIC a position far superior to its role as creditor. Throughout the life of the loan, River East ran the risk it would be unable to meet its loan obligations. This risk would have disappeared if VALIC reinvested the money into federal treasuries. Alternatively, VALIC could have reinvested the twenty million dollars in

168. *River E. Plaza, L.L.C.*, 498 F.3d at 721.

169. *Id.* at 722 (“Illinois will not enforce penalty clauses, . . . some liquidated damages clauses cross the line and become penalty clauses in disguise, the underlying question is whether this clause is punitive in nature.”).

170. *Id.*

171. *Id.* at 723.

172. *Id.*

173. *River E. Plaza, L.L.C.*, 498 F.3d at 723 (citing *Checkers Eight Ltd. v. Hawkins*, 241 F.3d 558, 562 (7th Cir. 2001)).

174. *Id.*

175. *Id.*

176. *Id.*

another commercial loan, thereby earning a return on the \$3.9 million comparable to the original loan with River East. Thus, VALIC could choose either a risk-free investment earning a return virtually identical to its original commercial loan or a commercial real estate mortgage with earnings that exceeded its original commercial loan. Yet, the \$3.9 million was intended to represent lost interest!

The prepayment provision created considerable opportunities for VALIC, but the Seventh Circuit did not find them persuasive. When River East argued that the prepayment provision overcompensated VALIC, the court vacuously demanded, “compared to what?”¹⁷⁷ According to the court, VALIC’s investment in risk-free treasuries would not compensate the lender as fully as the original loan.¹⁷⁸ The court’s puzzling explanation is flawed. Consider the court’s restatement of plaintiff’s argument: “[Plaintiff’s] unwritten assumption in such a formula is that VALIC can take the returned principal, invest it in Treasuries, and by taking the income from the Treasuries and adding it to the prepayment fee, VALIC gets the exact return it expected from the loan.”¹⁷⁹ This misstates the plaintiff’s position. Plaintiff asserted VALIC could invest the returned principal, interest, *and prepayment fee* in Treasuries. Such an investment would have given VALIC the expected return from the loan without any of the risk.

The court did not offer any reason for its conclusion that reinvestment into a comparable commercial loan would overcompensate the lender. Instead, the court found the following ironic:

In trying to argue that the prepayment clause is a penalty, which by definition is a clause whose sole purpose is to secure the performance of the contract, River East [claimed] that VALIC would have been effectively *worse* off if the contract had been repaid over the term of the loan instead of prepaid.¹⁸⁰

This purported irony did not prevent the court from acknowledging that if the lender had reinvested in a comparable commercial loan, it would have recovered more than it would have from the original loan:

[M]any players in the industry have adjusted their prepayment clauses to account for some of that cushion between the Treasury rate and the loan’s rate by adding . . . basis points to the discounted rate. . . . But even the lenders who are most generous, by adding twenty-five or fifty basis points to the Treasuries, would have made an “unreasonable” fee according to River East’s argument because

177. *Id.*

178. *River E. Plaza, L.L.C.*, 498 F.3d at 723.

179. *Id.*

180. *Id.*

*the fee would allow them to recover more from their future investments than they would have from the original borrower.*¹⁸¹

The court did not explain this apparent contradiction in its findings.

The court held for VALIC, with a terse explanation: “[A] contrary result would have broad implications for both lenders and borrowers . . . and might inadvertently effect a wide-ranging alteration of the law of real estate financing in Illinois. [This responsibility] rests with the courts of Illinois, and not with the federal courts”¹⁸² While the Seventh Circuit acknowledged that developments in Illinois law should come from the Illinois courts, the Seventh Circuit declined to certify the issue to the Illinois Supreme Court for instruction.

VII. AN UNADDRESSED ISSUE

Neither the Seventh Circuit nor the District Court addressed the relevance of the “lost volume seller” rule. VALIC could have argued its operations were akin to those of a volume seller, and therefore, the company was entitled to the benefit of the rule. A lost volume seller is one who would have made, for example, two sales and two profits rather than only one sale and one profit if the buyer had not breached the agreement.¹⁸³ Thus, even if VALIC had reinvested the prepaid principal in a new mortgage, VALIC would not have been fully compensated. VALIC presumably would have invested in an additional mortgage regardless of River East’s prepayment of its mortgage.

The lost volume seller rule is an exception to the general rule of mitigation, granting the seller the expectancy of both contracts, rather than requiring the seller to give up one expectancy interest to mitigate damages.¹⁸⁴ The rule, however, is “commonly understood to apply [only] to contracts involving the sale of consumer goods.”¹⁸⁵ Whether an Illinois court would apply the rule to a mortgage remains unresolved. However, even if the rule applied to mortgages, courts have the discretion to deny recovery of expectancy damages for public policy reasons.¹⁸⁶

181. *Id.* at 725 (emphasis added).

182. *Id.* at 725-26.

183. FISCHER, *supra* note 54, at § 13.8.2.

184. *Id.*

185. *Gianetti v. Norwalk Hosp.*, 833 A.2d 891, 897 (Conn. 2003) (holding that the rule also applies to personal service contracts).

186. *Wilson v. Los Angeles County Metro. Transit Auth.*, 1 P.3d 63, 70 (Cal. 2000).

VIII. BUSINESS AS USUAL

The Northern District analyzed a contractual provision without clear guidance from the Illinois Supreme Court, but it grounded its holding in generally recognized contract principles. Prepayment provisions fit well within the rubric of liquidated damages, and the Seventh Circuit should have upheld the district court decision. The Seventh Circuit also should have certified the issue for review by the Illinois Supreme Court.¹⁸⁷ Instead, the court crafted a disingenuous analysis, misstating and undermining River East's position.

The Northern District called attention to a problem now plaguing millions of Americans. Although the court considered a prepayment provision in the context of a commercial mortgage, the court's analysis was relevant to residential mortgages as well. Ultimately, whether or not to subject a prepayment provision to a liquidated damages analysis turns on the similarity of the prepayment provision to a liquidated damages provision. The analysis has nothing to do with whether the mortgage was commercial or residential. The Northern District's holding had ramifications for the entire lending industry in Illinois. The case marked an important break from the tradition of complete deference to the freedom of contract. Parties should have the ability to include freely negotiated terms, but given the broad public policy ramifications of prepayment provisions, courts should carefully scrutinize such provisions. For now, the law of mortgages remains mired in the past while tradition handcuffs justice.

IX. CHANGING THE STATUS QUO

The Federal Reserve Board¹⁸⁸ has cut interest rates aggressively.¹⁸⁹ As the rift between the rates on ARMs and federal funds expands, the opportunities for cash-strapped mortgagees created by refinancing are even more apparent.¹⁹⁰ If the current economic crisis continues, the

187. ILCS S. Cr. R. 20(A). Illinois Supreme Court Rule 20 provides that when the United States Court of Appeals for the Seventh Circuit has pending before it a case involving a question of State law that may be determinative, and the Illinois Supreme Court has no controlling precedents, the Seventh Circuit may certify the question to the Illinois Supreme Court for instruction. *Id.*

188. The Federal Reserve is the central bank of the United States. "The Federal Reserve exercises control over the demand for and supply of balances that depository institutions hold at the Reserve Banks. In so doing, it influences the federal funds rate, and ultimately, employment, output, and prices." THE FEDERAL RESERVE BOARD, PURPOSES & FUNCTIONS 27 (Federal Reserve Sys. ed., 9th ed. 2005) (1939), available at http://www.federalreserve.gov/pf/pdf/pf_3.pdf.

189. The Federal Reserve Board, *FRB: Monetary Policy, Open Market Operations*, (2008), available at <http://www.federalreserve.gov/fomc/fundsrate.htm>

190. This is true even though the federal fund rate does not always immediately translate into reduced mortgage rates. *See, e.g.,* John W. Schoen, *Why are mortgage rates up if the Fed is cut-*

problems created by prepayment provisions may become less relevant if lenders ridden with bad debt refuse to refinance subprime borrowers. If lenders cannot or will not offer refinancing to high-risk borrowers,¹⁹¹ then draconian prepayment provisions are less important. However, given the number of Americans currently trapped in high-rate ARMs, prepayment provisions remain relevant.

The problems raised by prepayment provisions are plaguing consumers, exacerbating the mortgage crisis already besetting the nation. Federal Reserve Chairman Bernanke expects delinquencies and foreclosures to continue to rise for the foreseeable future and continues to call for measures to reduce preventable foreclosures.¹⁹²

The government has been forced into action. While the decision to place Fannie Mae and Freddie Mac into conservatorship increased the likelihood that future Americans will be able to secure financing and purchase homes, it provided little relief to the ever-increasing number of mortgage foreclosures. Some in the government recognized the problem of prepayment provisions long before the subprime mortgage crisis began. For example, the Treasury Department (the "Treasury") formed a task force to analyze the problems of predatory lending in 2000.¹⁹³ The Treasury explained, "where the borrower refinances a loan with a prepayment penalty, the cost of that penalty may be financed in the new loan balance, driving up the overall price of the loan to the borrower."¹⁹⁴ The Treasury suggested further restrictions on prepayment penalties to make it more economical for some families to refinance their loans. "The ability to refinance at successively lower interest rates over time may allow more borrowers to graduate from the subprime to the prime market."¹⁹⁵ Unfortunately, these suggestions only applied to loans that refinanced existing mortgages charging more than ten percent above the yield on Treasuries.

ting?, MSNBC, Mar. 2, 2008, <http://www.msnbc.msn.com/id/23412069/> (quoting Federal Reserve Chairman Ben Bernanke, "Even as the Fed has lowered interest rates, and as the general pattern of interest rates has declined, the pressures in the credit markets have caused greater and greater spread, particular [sic] for risky borrowers . . .").

191. According to Chairman Bernanke:

In the past, subprime borrowers were often able to avoid resets by refinancing, but currently that avenue is largely closed. Borrowers are hampered not only by their lack of equity but also by the tighter credit conditions in mortgage markets. New securitizations of nonprime mortgages have virtually halted, and commercial banks have tightened their standards, especially for riskier mortgages. Indeed, the available evidence suggests that private lenders are originating few nonprime loans at any terms.

Bernanke, *supra* note 24.

192. *Id.*

193. Task Force, *supra* note 46.

194. *Id.* at 94.

195. *Id.* at 95.

Governor Kroszner¹⁹⁶ recently announced the intent of the Federal Reserve—whose plutocratic members bear much of the responsibility for this mess—to establish new rules allowing the subprime market to function in a way that is safe for borrowers and profitable for lenders. The proposal addresses “abusive lending practice and establishes new standards for subprime lending, prepayment penalties, escrow accounts, and verification of assets and income.”¹⁹⁷ The government needs to expand regulation of the lending industry,¹⁹⁸ even if expansion has little retroactive effect on homeowners trapped in high-cost mortgages. The proposal would limit prepayment penalties in “‘higher-priced mortgage loans’ secured by the consumer’s principal dwelling.”¹⁹⁹ Prepayment penalties would not apply for at least sixty days prior to any possible payment increases.²⁰⁰

In late 2007, Senator Christopher Dodd²⁰¹ introduced The Homeownership Preservation and Protection Act of 2007.²⁰² The Act would establish additional protection for subprime mortgages²⁰³ and bor-

196. Randall S. Kroszner, Ph.D. is a member of the Board of Governors of the Federal Reserve System of the United States and is the Governor responsible for banking regulation.

197. Brian Collins, *Fed Will Bolster Housing*, NAT’L MORTGAGE NEWS ONLINE, Jan. 14, 2008, <http://www.nationalmortgagenews.com/premium/archive/?id=158209>.

198. According to Randall Kroszner:

[I]n 2006, over 45% of high-cost first mortgages were originated by independent mortgage companies [which are not regulated by federal banking agencies]. In addition, prior to late 2005, high demand for housing and rising house prices allowed borrowers to recover from these risk through profitable home sales and refinancings [sic], hiding the weakened underwriting standards from view.

Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., Testimony Before the U.S. House of Representatives Comm. on Fin. Servs.: Loan Modifications and Foreclosure Prevention (Dec. 6, 2007) (transcript available at <http://www.federalreserve.gov/newsevents/testimony/kroszner20071206a.htm>).

199. According to the Federal Reserve Board:

The rule would define ‘higher-priced mortgage loan’ to capture loans in the subprime market but generally exclude loans in the prime market. A loan would be covered if it is a first-lien mortgage and has an annual percentage rate (APR) that is three percentage points or more above the yield on comparable Treasury notes, or if it is a subordinate-lien mortgage with an APR exceeding the comparable Treasury rate by five points or more.

Press Release, Governors of the Federal Reserve System (Dec. 18, 2007) (available at <http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm>).

200. *Id.*

201. Senator Christopher J. Dodd (D-CT) has been a member of Congress for more than thirty-eight years. He is currently the chairman of the United States Senate Committee on Banking, Housing, and Urban Affairs. This committee has jurisdiction over all matters relating to banks, banking, financial institutions, and the Federal Reserve System.

202. Home Ownership and Protection Act of 2007, S. 2452, 110th Cong. (2007).

203. The Act defines subprime mortgages as “[m]ortgages that have interest rates that are 3 percentage points higher than Treasury securities of comparable maturities for first mortgages and 5 percentage points for second mortgages.” *Id.*

rowers who obtain nontraditional mortgages.²⁰⁴ Among other things, the Act would prohibit prepayment penalties on subprime loans.²⁰⁵ Recently, Senator Richard Durbin²⁰⁶ announced legislation to address problems of prepayment penalties in the bankruptcy context. According to Senator Durbin, the “Helping Families Save Their Homes In Bankruptcy Act of 2007” would help over 600,000 people facing foreclosure.²⁰⁷ Under current law, bankruptcy judges cannot modify the terms of the first mortgage on a consumer’s principal residence.²⁰⁸ Senator Durbin’s Act would allow, among other things, bankruptcy judges to waive prepayment provisions.

Congress could extend a bailout to borrowers without jeopardizing taxpayer dollars. Such a bailout would benefit people with decent jobs and incomes, who could afford a normal mortgage, by extricating them from the exotic loans and prepayment penalties threatening to cost them their primary residences.²⁰⁹

This could also be a chance for federalism to shine. A number of states, fed up with the time it has taken Congress to act, have adopted legislation to protect their homeowners.²¹⁰ The bills run the gamut, from restricting prepayment penalties on all loans to requiring lenders to offer prospective borrowers loans without prepayment penalties.²¹¹

204. *Id.*

205. *Id.*

206. Senator Dick Durbin (D-Ill.) is the Majority Whip of the U.S. Senate, the second highest position in the party leadership in the Senate.

207. *New Report Underscores Need for Durbin Mortgage Foreclosure Bill*, UNITED STATES SENATOR DICK DURBIN, NOV. 14, 2007, <http://durbin.senate.gov/showRelease.cfm?releaseId=287492>. “Today, virtually every type of personal debt, including vacation homes and family farms, can be restructured in bankruptcy with the exception of mortgages on a primary residence. This exception dates to the 1970’s, when most mortgages were fixed rate, long term agreements.” *Id.*

208. Michael A. Hiltzik, *Lenders derail home relief plan*, L.A. TIMES, April 22, 2008, available at <http://articles.latimes.com/2008/apr/22/business/fi-bankrupt22>.

209. John W. Schoen, *Should Congress Bailout Borrowers in Trouble*, MSNBC, Sept. 9, 2007, available at <http://www.msnbc.msn.com/id/20647417/>. “By identifying those with relatively good credit, nullifying the prepayment penalty, and letting them back under the risk umbrella of FHA insurance or the Freddie Mac or Fannie Mae conforming loans that they should have been sold in the first place, you could also lower their payments.” *Id.*

210. Alison Vekshin, *States Push Subprime-Lending Laws as Congress Lags*, BLOOMBERG.COM, July 10, 2007, available at <http://www.bloomberg.com/apps/news?pid=20670001&refer=politics&sid=a2OzDA13SxJM> (quoting Minnesota Attorney General Lori Swanson).

211. *Id.* As discussed earlier, borrowers in Illinois already have some protections from unfair or predatory lending practices.

Specifically, subprime loans made for refinances that exceed certain triggers — such as an interest rate that is 6 percentage points higher than the prevailing rate on U.S. Treasury securities of comparable maturity — can’t have a prepayment penalty in effect for more than the first three years of the loan. Moreover, the penalty can’t then exceed 3

X. CONCLUSION

Until and unless Congress acts, the duty of protecting homeowners from abusive lenders falls to the state governments and courts. Unfortunately, *River East*²¹² effectively negates the possibility that federal courts will shield homeowners from crippling prepayment penalties. While the Seventh Circuit decision does not bind state courts, challenges to the enforceability of prepayment provisions will often find venue in the district courts, due to the diversity of jurisdiction between borrowers and lenders. Moreover, the Seventh Circuit's decision has persuasive value for state courts.

Therefore, it is unfortunate the Seventh Circuit did not devote the time or effort necessary to craft a more thoughtful analysis. The court properly recognized the need for significant changes in state law, yet the court failed to certify the issue for review by the Illinois Supreme Court. Although the district court decision would have granted some relief to cash-strapped mortgagees, the appellate court effectively maintained the status quo by misstating the plaintiffs' arguments and ignoring the punitive aspects of the prepayment provision. Maintaining the status quo is crippling the nation.

percent of the loan principal during the first year, 2 percent in the second and 1 percent in the third.

Marilyn Kennedy Melia, *The Penalty for Early Payoff*, CHI. TRIB., Feb. 20, 2005, available at <http://www.chicagotribune.com/classified/realestate/financing/chi-0502200479feb20,0,5872970>. story.

212. *River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, 498 F.3d 718, 721 (7th Cir. 2007).

