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The Story of YMPs ("Yield Maintenance Premiums") in Bankruptcy

Ingrid Michelsen Hillinger*

&

Michael G. Hillinger**

I. INTRODUCTION

A. General

A YMP is a yield maintenance premium or early loan termination fee. A YMP seeks to compensate a lender "for the anticipated interest [the] lender will not receive if [its] loan is paid off prematurely. . . . [A] prepayment premium insures the lender against loss of [its] bargain if interest rates decline."¹ In an earlier iteration, YMPs were known as "prepayment penalties." Drafters of lending agreements soon realized the term "prepayment penalty" was a poor word choice. A lender lost its right to any prepayment penalty when it accelerated the debt. After acceleration, prepayment is not possible because full payment is presently due. Moreover, courts treat and test early loan termination fees as attempts to stipulate damages.² As the Restatement of Contracts provides, "[a] term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a *penalty*."³ The parties' own characterization of early loan termination fees as penalties helped courts to invalidate them.

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1. *In re LHD Realty Corp.*, 726 F.2d 327, 330 (7th Cir. 1984).

2. See, e.g., *Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass'n (In re Imperial Coronado Partners, Ltd.)*, 96 B.R. 997 (9th Cir. B.A.P. 1989); *In re 433 South Beverly Drive*, 117 B.R. 563 (Bankr. C.D. Cal. 1990); *In re A.J. Lane & Co.*, 113 B.R. 821 (Bankr. D. Mass. 1990); *Conn. Gen. Life Ins. Co. v. Schaumburg Hotel Owner L.P. (In re Schaumburg Hotel Owner L.P.)*, 97 B.R. 943 (Bankr. N.D. Ill. 1989); *In re Planvest Equity Income Partners IV*, 94 B.R. 644 (Bankr. D. Ariz. 1988); *In re Kroh Bros. Dev. Co.*, 88 B.R. 997 (Bankr. W.D. Mo. 1988); *In re Skyler Ridge*, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987).

3. RESTATEMENT (SECOND) OF CONTRACTS, § 365(1) (1981) (emphasis added).

As a general proposition, YMPs do not raise eyebrows. A lender may

enter into a loan agreement that protects it from loss of interest through premature repayment of a loan. Otherwise, a lender that has priced a loan based upon the expectation of a long-term commitment to the contractual interest rate can be frustrated by a refinancing after the filing of a bankruptcy case at a time of lower interest rates. If secured lenders and borrowers want to contract to protect a secured lender's interest rate through the payment of reasonably calculated liquidated damages, there is no bankruptcy policy to prohibit the enforcement of such a provision.⁴

YMPs are a routine, ho hum fact of lending life outside of bankruptcy.⁵ They are not so "ho hum" in bankruptcy.⁶ Bankruptcy is a

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach and, the difficulties of proof of loss, loss and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Revised U.C.C. § 2-718(1), available at <http://www.law.upenn.edu/bll/ulc/ucc2/annual2002.htm>.

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, loss and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. Section 2-719 determines the enforceability of a term that limits but does not liquidate damages.

Revised U.C.C. § 2-718(1), proposed cmt. 1, available at <http://www.law.upenn.edu/bll/ulc/ucc2/annual2002.htm>.

Changes: This section contains the following changes from original Section 2-718:

- a) In subsection (a), the requirements that the party seeking to enforce a term liquidating damages demonstrate "difficulties of proof of loss" and "inconvenience or nonfeasibility of otherwise obtaining an adequate remedy" have been eliminated in commercial contracts.
- b) In subsection (a), the sentence "[a] term fixing unreasonably large liquidated damages is void as a penalty" has been eliminated as unnecessary and capable of causing confusion.
- c) The last sentence of subsection (a) has been added to clarify the relationship between this section and Section 2-719.

Id.

4. *Skyler Ridge*, 80 B.R. at 508.

5. For example, in *Investment 9725 v. Bankers United Life Assurance Co.*, 292 F. Supp. 2d 1140 (E.D. Wis. 2003), the parties debated the proper interpretation of the YMP. *Id.* at 1140. The issue of its validity or enforceability was never mentioned. *Id.* One commentator discussed the advantages and disadvantages of a YMP in the commercial mortgage-backed securities arena. George Lefcoe, *Yield Maintenance & Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment*, 28 REAL EST. L.J. 202 (2000).

6. That is not to say that YMPs in a bankruptcy context raise the eyebrows of all courts. Some enforce a YMP as a matter of freedom of contract. See, e.g., *In re Fin. Ctr. Assocs.*, 140 B.R. 829, 837-38 (Bankr. E.D.N.Y. 1992) (discussing the magnitude of loan transactions and quality and quantity of loan documents established arms-length transaction between adequately represented sophisticated parties: "It would be offensive to the basic notion of freedom of contract if the Debtor's argument were to prevail."). See also *United Merchs. & Mfrs., Inc. v. Equitable Life*, 674 F.2d 134 (2d Cir. 1982); *In re Lappin Elec. Co.*, 245 B.R. 326, 331 (Bankr. E.D. Wis. 2000)

closed system. If a debtor is insolvent, recognition of a YMP, at a minimum, means more to the YMP holder which means less to everyone else. In one case, recognition of the YMP meant no other creditor would receive any distribution.⁷ In a chapter 11 case, recognition of a YMP can undermine a debtor's ability to reorganize. A successful reorganization requires confirmation of a plan. Confirmation requires the bankruptcy court to conclude the proposed plan is feasible.⁸ Recognition of a lender's YMP-enhanced claim might make a plan unfeasible because the debtor cannot afford the larger payout required to satisfy the lender's claim.

This article tries to tell the story of YMPs in bankruptcy. It is not an easy story to tell. It has so many subplots: the court's position on freedom of contract, the debtor's solvency or insolvency, the effect of recognizing the YMP on other creditors,⁹ whether the YMP claim arose pre- or post-petition, the proper relationship between section 502 claim allowance and section 506(b) which permits oversecured claims to include reasonable fees, costs, or charges as provided for in the loan agreement,¹⁰ and the effect of YMP enforcement on chapter 11 plan confirmation.

In terms of basic plot line though, the debtor will almost always want to get rid of the YMP - somehow, some way. The YMP holder will almost always want to enforce it.¹¹ The debtor's other creditors will join with the debtor to oppose YMP enforcement if enforcement

(holding that liquidated damages provision enforceable even though creditor suffered no damage because formula was reasonable calculation of damages for early termination, the parties agreed to it, they were sophisticated, they were represented by competent counsel, and transaction was voluntary and at arm's length).

7. *Kroh Bros.*, 88 B.R. at 1002.

8. 11 U.S.C. § 1129 states the requirements for confirmation of a chapter 11 plan. 11 U.S.C. § 1129 (2001). A court cannot confirm a plan unless it is feasible. *Id.* "Confirmation . . . is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." 11 U.S.C. § 1129(a)(11) (2001). See, e.g., *In re Ridgewood Apts.*, 174 B.R. 712, 716 (Bankr. S.D. Ohio 1994) (ruling on creditor's claim critical for determining plan feasibility); *Skylar Ridge*, 80 B.R. at 503 (stating that the viability of proposed plan depends on disallowance of prepayment premium claim).

9. *In re Pub. Serv. Co. of N.H.*, 114 B.R. 813, 818 (Bankr. D.N.H. 1990).

10. 11 U.S.C. § 506(b) (2001).

11. According to some courts, a creditor's secured claim cannot include both a YMP and the contract default rate of interest. The court in *In re AE Hotel Venture*, 321 B.R. 209 (Bankr. N.D. Ill. 2005) explained:

[The oversecured creditor's] claim for *default* interest - the additional 5% interest that began accruing upon AE Hotel's default — is another matter. Generally speaking, interest compensates for the delay in receiving money owed: "the loss of the time value of money." . . . [The creditor] arrived at the interest rate it believed would compensate for that loss in the Note That being so, the difference between the original rate and the . . . default rate . . . could not have meant to perform the usual function of

will adversely affect their position.¹² The YMP story then is really a story about how debtors can try to invalidate or neutralize YMPs and how YMP holders can try to make them enforceable.

B. *The Relationship between a YMP and Section 1129(a)(7)(A)(ii)'s "Best Interests of Creditors" Test*

Perhaps the most profound effect of recognizing a YMP occurs in the chapter 11 plan confirmation context. Section 1129 states the requirements for a confirmable plan. A court cannot confirm a proposed plan unless it satisfies section 1129. Section 1129(a)(7)(A)(ii) states what is called the "best interests of creditors" test. It applies to nonaccepting members of *impaired*¹³ classes of claims (creditors)¹⁴ and interest holders (owners). According to section 1129(a)(7)(A)(ii), a court cannot confirm a plan unless the plan gives dissenting¹⁵ mem-

interest. The time value of [the creditor's] money . . . did not magically increase by 5% once [the debtor] defaulted.

Default interest is instead designed to reimburse creditors for "extra costs incurred after default." Default interest, then, is not true interest at all. It is a form of late charge and thus is a "charge" for purposes of section 506(b). . . .

Because [the creditor's] default interest is actually a charge, it must be "reasonable" to be allowed. . . . Default interest is not a "reasonable" charge, however, because it compensates for an injury that has already been compensated in some other way under the parties' agreement.

Id. at 215. *But see In re Vanderveer Estates Holdings*, 283 B.R. 122, 134 (Bankr. E.D.N.Y. 2002) (holding, in context of solvent debtor, creditor can recover both YMP and default interest because a YMP is structured to provide creditor with present value of the interest it loses from prepayment, whereas default interest compensates for administrative expenses and inconvenience of monitoring untimely payments).

12. If a debtor is solvent, all creditors, by definition, will receive payment in full. If so, the YMP battle will involve only the debtor and the secured creditor-YMP holder. *See, e.g., Welzel v. Advocate Realty Investments, LLC (In re Welzel)*, 275 F.3d 1308 (11th Cir. 2001) (en banc) (attorney's fees), *In re 360 Inns, Ltd.*, 76 B.R. 573 (Bankr. N.D. Tex. 1987) (YMP).

13. 11 U.S.C. § 1124 (2001) defines nonimpairment. For purposes of this article, "impairment" means *any* alteration in a creditor's legal, equitable or contractual rights. The nature of the alteration - for good or for bad - is irrelevant. *In re Barrington Oaks General P'ship*, 15 B.R. 952, 967-68 (Bankr. D. Utah 1981). It is the fact of change in rights, not the nature of the change, that establishes impairment. Most plans impair most classes. Hence, in most cases, § 1129(a)(7) applies.

14. 11 U.S.C. § 101(5) (2000) (defining "claim") and 11 U.S.C. § 101(10) (2000) (defining "creditor").

15. Impaired classes of claims and interest holders are entitled to vote on a chapter 11 plan. Section 1124 defines impairment. 11 U.S.C. § 1124 (2000). Section 1126 states when a class accepts a plan. 11 U.S.C. § 1126 (2000). According to § 1126(c), a class of claims accepts a plan if at least two-thirds in amount and more than half in number of those voting accept. § 1126(c). A class of interests accepts if two thirds in amount of those voting accept. § 1126(d).

Section 1129(a)(7) is stated in the alternative. Each member of an impaired class must either vote to accept the proposed plan *or* receive what it would have received in a hypothetical liquidation on the effective date of the plan.

bers of an impaired class of claims at least what they would receive “if the debtor were liquidated under chapter 7 of this title on”¹⁶ the effective date of the plan.¹⁷ To determine what the “best interests of creditors” test requires for a class of creditors, one must do a hypothetical chapter 7 liquidation analysis to determine what creditors in that class would receive in a chapter 7 case.¹⁸ The plan must provide dissenting creditors with at least that much or the court cannot confirm the plan.¹⁹

At a minimum, recognizing a YMP as part of the lender’s secured claim will increase the amount the lender must receive under a plan to satisfy the best interests test. That could decrease what other creditors receive under the plan. It could also negate the possibility of confirmation by rendering the plan unfeasible.

C. *A Hypothetical*

A simple hypothetical demonstrates the connection between a YMP and section 1129(a)(7)’s “best interests of creditors” test. Assume D borrows \$10 million from C in year 1. C’s loan is secured by a valid interest in Blackacre, valued at \$15 million. D promises to repay C \$10 million over thirty years at ten percent interest. The loan agreement requires D to pay C an additional \$2 million if D prepays the loan during the first ten years.

In year 2, D petitions for chapter 11 relief. Assume C’s allowed claim is \$10 million without the YMP and \$12 million with it. Blackacre is still valued at \$15 million. Therefore, C’s claim is oversecured. D’s plan puts C in its own class. Under the plan, C will retain its lien

16. 11 U.S.C. § 1129(a)(7)(A)(ii) (2000).

17. The “best interests of creditors” test also applies to dissenting members of an impaired class of interest holders. The point is unimportant in the context of YMPs which are held by creditors, typically secured creditors.

18. 11 U.S.C. § 726 details the chapter 7 distribution scheme. 11 U.S.C. § 726 (2000). Essentially, after secured claims are paid or the collateral is surrendered to the lien holder, the chapter 7 trustee must first pay all priority claims described in section 507 in the order in which they are listed there. § 726(a)(1). Next the trustee must pay all nonpriority, timely filed unsecured claims. § 726(a)(2). Thereafter, late filed nonpriority unsecured claims. § 726(a)(3). After that come punitive, that is, noncompensatory penalties, fines, forfeitures and damages. § 726(a)(4). The fifth rung entitles claim holders to interest. § 726(a)(5).

19. Section 1129(a)(7)(A)(ii) only applies to dissenting members of a class. 11 U.S.C. § 1129(a)(7)(A)(ii) (2000). However, section 1123(a)(4) provides that a plan must provide the same treatment for all members of a class unless a member agrees to less favorable treatment. 11 U.S.C. § 1123(a)(4) (2000). Because a plan proponent must assume some members of an impaired class will object and therefore, the plan must satisfy the best interests test as to them and the plan must provide the same treatment for all members of a class, a plan will propose to give any impaired class at least what its members would receive in a liquidation. The “best interests” test establishes a floor, a minimum treatment the plan will provide.

in Blackacre. Moreover, C will receive deferred cash payments with a present value equal to \$10 million. The plan nowhere provides for C's YMP.

C is indignant (as well as hostile to D's reorganization attempt). C votes to reject the plan. Moreover, C objects to confirmation of the plan at the plan confirmation hearing. C makes the following argument: D's plan alters its contractual and legal rights because it does not provide for C's YMP. Therefore, D's plan impairs its claim and section 1129(a)(7) applies. C did not accept D's plan. Consequently, the court cannot confirm D's plan unless C receives under the plan at least what it would have received in a hypothetical liquidation on the plan's effective date. In a hypothetical liquidation, C would have received \$12 million in cash — its \$10 million in principal and its \$2 million YMP.

But wait. D's plan is not proposing to prepay C's loan. If D is not prepaying, is C's YMP even triggered? Yes, it is. It is triggered because prepayment *would* occur in a *liquidation*. A liquidation *would* result in prepayment. In a liquidation, therefore, C *would* be entitled to its YMP. In a hypothetical chapter 7 liquidation on the effective date of the plan, C would receive \$12 million, not \$10 million. Thus, confirmation of D's plan would require cash payments to C having a present value equal to \$12 million, not \$10 million.

Concluding that a lender's secured claim includes the YMP can make a big difference. Paying the present value of \$10 million over time is different from paying the present value of \$12 million. Recognizing a YMP in bankruptcy permits the YMP holder to lessen the trauma of its borrower's bankruptcy. A YMP can protect the lender against the loss that results when its borrower "re-writes" the loan in its chapter 11 plan. From a lender's perspective, a YMP is a nifty device. And we hasten to add, some YMPs are hardly "ymp change."²⁰

The above hypothetical assumes two things: (1) the YMP is enforceable, and (2) the YMP is triggered. And therein lies the tale. As Judge Yacos observed, "whether prepayment premiums . . . are enforceable . . . is not a sterile theoretical analytical activity under the case law. The courts actually engage in a fact-specific inquiry into the particular circumstances surrounding the secured creditor and the debtor in the bankruptcy proceeding."²¹ The debtor's status as solvent or insolvent seems to influence the outcome of many cases in-

20. See, e.g., *Pub. Serv.*, 114 B.R. 813 (\$9.3 million YMP); *Kroh Bros.*, 88 B.R. 997 (\$2,173,000 YMP); *In re Hidden Lake L.P.*, 247 B.R. 722, 725 (Bankr. S.D. Ohio 2000) (\$2,699,487 YMP).

21. *Pub. Serv.*, 114 B.R. at 818.

volving YMPs. If a debtor is insolvent, recognition of a YMP can diminish if not eliminate any payout to unsecured creditors.²² It might even quash the debtor's reorganization.²³ When a debtor is solvent, the only protagonists are the debtor and the lender. They are fighting over who gets the money. In that situation, there is no reason not to enforce the contract the parties freely made. There is no reason not to give the lender the benefit of its bargain.²⁴

Most chapter 11 debtors are not solvent. In most cases, then, recognition of a lender's YMP will adversely affect the debtor's other creditors. The story of YMPs is a story of judicial and lender ingenuity. As courts devise ways to deny effect to a YMP, lenders have drafted new, improved YMPs. Although the story will continue to unfold, at the moment, lenders with carefully drafted YMPs appear to have the edge.

II. YMPs AND SECTION 502(B)(2)

A YMP seeks to compensate a creditor "for the anticipated interest a lender will not receive if the loan is paid off prematurely."²⁵ Seemingly, anticipated interest is unearned or unmatured interest. Section 502(b)(2) disallows interest that is unmatured as of the date of a bankruptcy petition. Does section 502(b)(2) disallow YMPs?

In *In re Ridgewood Apartments*,²⁶ the court concluded the YMP represented unmatured interest, and therefore section 502(b)(2) disallowed it.²⁷ The secured creditor in *Ridgewood*, Fannie Mae, was undersecured. Fannie Mae took the position that its claim included the YMP because its loan agreement with the debtor provided for a prepayment premium and the YMP was triggered prepetition when it accelerated the debtor's obligation.

The court scrutinized the loan documents to conclude the prepayment premium was only triggered upon prepayment. "Had Fannie Mae intended the penalty to be payable upon acceleration, the [contract] should have stated that specifically."²⁸ The court went on to

22. See, e.g., *Kroh Bros.*, 88 B.R. at 999 (noting that if YMP allowed, no other creditor will receive any distribution).

23. See, e.g., *Ridgewood Apts.*, 174 B.R. at 716 (ruling on creditor's claim critical for determining plan feasibility); *Skyler Ridge*, 80 B.R. at 503 (viability of proposed plan depends on disallowance of prepayment premium claim).

24. See *Vanderveer Estates Holdings*, 283 B.R. 122; *360 Inns*, 76 B.R. 573.

25. *LHD Realty*, 726 F.2d at 330.

26. 174 B.R. 712 (Bankr. S.D. Ohio 1994).

27. *Id.* at 721.

28. *Id.* at 720. (emphasis added).

explain why a contrary conclusion would run counter to bankruptcy's goals:

the essence of a bankruptcy reorganization under chapter 11 is to restructure debt, decelerate debts, and adjust debtor-creditor relationships. It would be anomalous for acceleration of an obligation to be construed as a prepayment which triggered the application of a penalty. Even without specific contractual language, a bankruptcy filing acts as an acceleration of all a debtor's obligations.²⁹

Prepetition, the debtor had not prepaid the note nor did the debtor's plan propose to do so. Therefore, "no prepayment penalty was due or owing prior to the debtor's bankruptcy filing and such an amount is not properly part of Fannie Mae's claim."³⁰ It was only a short step from there to the conclusion that Fannie Mae's claim for the prepayment premium was a contingent claim at the commencement of the debtor's bankruptcy case. It was contingent because prepayment had not occurred at that point. That contingent claim was for unmatured interest. That contingent claim for unmatured interest was held by an undersecured creditor. Undersecured creditors are not entitled to postpetition interest.³¹ The YMP had fallen on its own sword.

The clear purpose for a prepayment penalty is to compensate the lender for the risk that market rates of interest at the time of prepayment might be lower than the rate of the loan being prepaid. Such a provision would compensate the lender for anticipated interest that would not be received if the loan were paid prematurely. . . . As an attempt to compensate the lender for potential loss in interest income, Fannie Mae's claim for a prepayment penalty is not allowed under . . . section 502(b)(2).³²

Invalidating a lender's right to a YMP as unmatured interest will not work if the loan documents provide that the prepayment charge is due and payable in the event of any voluntary or involuntary prepayment including acceleration and the lender accelerates the debt prepetition. After acceleration, the interest is no longer unmatured. It becomes due upon acceleration. And so the very same judge who invalidated the YMP in *Ridgewood Apartments* as unmatured interest concluded section 502(b)(2) did not disallow the YMP when the creditor had accelerated the debt prepetition.³³

29. *Id.*

30. *Id.*

31. *United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 382 (1988).

32. *Ridgewood Apts.*, 174 B.R. at 720-21.

33. *Hidden Lake*, 247 B.R. at 730. The court noted a different result might have obtained had no acceleration occurred prepetition and the note had given the creditor a right to accelerate upon the debtor's filing of bankruptcy. *Id.* "Under the facts of this case, however, the Court agrees with the existing case law that a prepayment charge imposed prepetition is not a claim for

Today, the chance of invalidating a YMP as unearned interest seems remote. As another Ohio bankruptcy court explained in *In re Outdoor Sports Headquarters*, “prepayment amounts . . . do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract.”³⁴ As the court saw it, a creditor has a right to receive the prepayment premium “if payment of the entire amount due . . . is made prior to the full term of the contract.”³⁵ Said another way, “prepayment premiums . . . fully mature at the time of breach and [therefore] do not represent unmatured interest.”³⁶

Moreover, even if a YMP represents a right to unearned interest as of the petition date, that will not invalidate it if the YMP holder is oversecured. Section 506(b) permits oversecured claims to accrue postpetition interest. And, in fact, most of the case law involving YMPs in bankruptcy involves oversecured creditors. And curiously (or maybe, *not* so curiously), the courts do not characterize the YMP as unmatured interest. Rather, the YMP is a “charge.” Section 506(b) recognizes (allows) “reasonable charges provided for under the agreement”³⁷

III. THE VOLUNTARY/INVOLUNTARY DISTINCTION

In some cases, a court has refused to enforce the YMP because prepayment was not “voluntary.” The court, somewhat mysteriously, holds an involuntary payment does not trigger the YMP. Characterizing the nature of the prepayment as “involuntary” can seem like a magical incantation which, when recited by the court, makes the YMP disappear. For example, one court wrote that the lender’s “argument that it would be entitled to the prepayment penalty in a liquidation is not persuasive because payment of the debt resulting from liquidation would not constitute a ‘voluntary’ prepayment.”³⁸ Say what? The court went on to observe that “it is recognized that a debtor’s disposition of property under a Chapter 11 may be *involuntary*.”³⁹ Why should a debtor’s *involuntary* prepayment fail to trigger the YMP?

unmatured interest within the meaning of § 502(b)(2).” *Id.* See also *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); *Skyler Ridge*, 80 B.R. at 508.

34. 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993).

35. *Id.*

36. *Skyler Ridge*, 80 B.R. at 508 (emphasis added) (citing *360 Inns*, 76 B.R. at 576).

37. 11 U.S.C. § 506(b) (2000). Arguably, § 506(b)’s reasonableness requirement is limited to fees, costs and charges and does not apply to postpetition interest.

38. *Planvest Equity Income Partners IV*, 94 B.R. at 644.

39. *Id.* (emphasis in original).

The court's discussion in *In re Public Service Company of New Hampshire*⁴⁰ sheds light on the opaque voluntary/involuntary distinction. In *Public Service*, the creditors were senior secured bondholders. The bonds provided for a prepayment premium *if the borrower, at its option, prepaid the bonds*. The court went to great lengths to describe why nothing about the debtor's chapter 11 filing or its treatment of the bondholders constituted "an exercise of a voluntary 'option' by the borrower."⁴¹ The debtor was forced to seek chapter 11 relief because it could not recover the costs of its completed but unlicensed nuclear plant.⁴² The YMP was triggered only by a "'voluntary' call for a redemption of the bonds in the 'option of the Company' sense intended by the indentures involved."⁴³ The plan provision for paying the bonds was also not voluntary because the debtor had lost its exclusivity period and the plan's treatment was principally a product of a "takeover plan by another utility."⁴⁴ Because the bonds defined the circumstances triggering the YMP and those circumstances never occurred, the bondholders' claim did not include the YMP.⁴⁵

The facts in *In re Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass'n (In re Imperial Coronado Partners, Ltd.)*⁴⁶ were similar. The loan agreement allowed the borrower to pay off the loan early if the borrower paid the prepayment premium. "In general, such a provision is interpreted to mean that the prepayment premium is allowed only where the prepayment is voluntary."⁴⁷ Two judges of the B.A.P. panel concluded the debtor's section 363 sale of the property was voluntary, rendering its prepayment of the lender's loan voluntary. According to the majority, it was not a question of whether the debtor, as a practical matter, could afford to exercise its right to reinstate the loan. Rather, it was a question of "whether it had the right to reinstate the loan. It did."⁴⁸ For the majority, the debtor had assessed its situation and had decided that it made more business sense to sell the property than to reinstate the loan. It was a "conscious decision" on the debtor's part.⁴⁹ Therefore, "the decision to sell the

40. 114 B.R. 813 (Bankr. D.N.H. 1990).

41. *Id.* at 819.

42. *Id.* at 815.

43. *Id.* at 818.

44. *Id.* at 819.

45. See also *LHD Realty*, 726 F.2d 327.

46. 96 B.R. 997 (9th Cir. B.A.P. 1989).

47. *Id.* at 999.

48. *Id.* at 1000.

49. *Id.*

property and pay off the loan was voluntary, and the prepayment premium . . . [was] enforceable.”⁵⁰

According to the dissent, “payments made pursuant to judicial action are uniformly defined as involuntary”⁵¹ Because the court had ordered a sale of the property under section 363, the debtor’s payment was involuntary. Moreover, most parties who file bankruptcy have few meaningful options. An approach that enforces a penalty provision when a debtor’s only feasible alternative is to sell property and pay off the lender is an approach that favors form over substance and ignores bankruptcy’s equitable nature.⁵²

A chapter 7 liquidation results in an involuntary payment. If the YMP is only triggered when the borrower *elects* to prepay, a lender would not be entitled to its YMP in a debtor’s liquidation. Moreover, section 1129(a)(7)’s “best interests of creditors” test would not require the debtor’s plan to include the YMP as part of the lender’s claim. A creditor must receive under the plan at least what it would have received in a hypothetical liquidation on the effective date of the plan. If a YMP is only triggered by a debtor’s voluntary payment and a chapter 7 liquidation involves an involuntary payment, the lender would not be entitled to the YMP in a liquidation. Consequently, a court could confirm a plan even if it did not provide for the lender’s YMP.⁵³

From a lender’s perspective, the moral of this part of the case law story is clear. Do not condition a YMP on the borrower’s option or election to prepay. And so, Fannie Mae’s loan documents in *In re Ridgewood Apts.* provided that “the prepayment premium would be due whether the prepayment is voluntary or involuntary (in connection with Lender’s acceleration of the unpaid principal balance of the Note) or the Instrument is satisfied or released by foreclosure (whether by power of sale or judicial proceeding), deed in lieu of foreclosure or by any other means.”⁵⁴ Another more recently drafted YMP took a different tack. It provided:

if after an event of default and “at any time prior to a sale of the Mortgaged Property . . . either through foreclosure or the exercise of other remedies available to the Payee, [the debtor] pays an amount sufficient to satisfy the debt under the Note, that payment

50. *Id.*

51. *Imperial Coronado Partners*, 96 B.R. at 1001.

52. *Id.*

53. *See Pub. Serv.*, 114 B.R. at 819 (noting that in liquidation, bondholders would not receive prepayment premium because redemption would not be voluntary).

54. *Ridgewood Apts.*, 174 B.R. at 720; *see also Vanderveer Estates Holdings*, 283 B.R. 122 at 125.

will be deemed "a voluntary repayment" and [the debtor] will be obligated to pay an additional "prepayment consideration."⁵⁵

IV. WAIVER OF A YMP

According to the case law, a lender can waive its right to a prepayment premium. Courts finding a waiver typically rely on *In re LHD Realty Corp.*⁵⁶ to support their conclusion. In *LHD Realty*, the Seventh Circuit had no problem recognizing the general validity of reasonable prepayment premiums.⁵⁷ The court believed YMPs serve a valid purpose - they compensate lenders for anticipated interest they will not receive if prepayment occurs.⁵⁸ But the court acknowledged some limitations on a lender's right to receive such a prepayment premium. For instance, the lender who chooses to accelerate its debt loses its right to such a premium.⁵⁹ Why? "[B]ecause acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not *prepayment* but instead is *payment made after maturity*."⁶⁰

According to the court, when the lender has the option to accelerate,

it is only necessary that the mortgagee show an *unmistakable intention to exercise the option* and this may be done by taking steps for foreclosure, filing a foreclosure suit, sale pursuant to the mortgage or advertisement of the property for sale pursuant to the terms of a mortgage.⁶¹

The court concluded the lender had exercised its option to accelerate at the latest when it sought relief from the automatic stay.⁶² The court characterized the lender's action as sensible. No doubt, "it preferred . . . accelerated payment over the 'opportunity' to earn interest from the . . . loan over a period of years."⁶³

55. *AE Hotel Venture*, 321 B.R. at 213. As the court noted, parties by appropriate contract provisions can overcome the usual effect of acceleration on the enforceability of a YMP. *Id.* at 218.

56. 726 F.2d 327 (7th Cir. 1984).

57. *Id.* at 330.

58. *Id.*

59. *Id.*

60. *Id.* at 330-331 (emphasis added). The court noted two other limitations: prepayment when property is condemned by the government exercising its power of eminent domain and prepayment when mortgaged property is destroyed by "an insured-against casualty such as a fire." *Id.* at 331.

61. *LHD Realty*, 726 F.2d at 331.

62. *Id.*

63. *Id.*

The lender argued that a rule precluding lenders from a prepayment premium upon acceleration would encourage borrowers to intentionally default - to invite acceleration and foreclosure - because that would negate the premium. The court rejected the argument, both because it was implausible given the other ramifications of default for a borrower and because courts could refuse to apply the acceleration exception in the face of borrower abuse.⁶⁴

LHD Realty counsels lenders to forbear from exercising their option to accelerate. Such forbearance will preserve their right to enforce “an otherwise valid prepayment premium.”⁶⁵

The court in *In re Pinebrook, Ltd.*⁶⁶ suggested a further rationale for the waiver rule announced in *LHD Realty*. Basically, the *Pinebrook* court took a lender-can't-have-its-cake-and-eat-it-too approach. If a lender demands immediate payment by accelerating the indebtedness, it can't then penalize the debtor for prepaying pursuant to that demand. “It is this Court's understanding that a party is not entitled to both an acceleration of its debt *and* a prepayment penalty.”⁶⁷

In *Public Service of New Hampshire*, the court found a waiver in the indenture trustees' consistent opposition to any plan that did not cash out their bondholders.⁶⁸ In *LHD Realty*, the lender's motion for relief from the stay was sufficient conduct to establish the lender's intention to exercise its option to accelerate.⁶⁹

Every schoolchild knows that the filing of bankruptcy accelerates all debts.⁷⁰ Will bankruptcy's automatic acceleration eliminate a lender's right to a YMP? According to one court, no.⁷¹ If bankruptcy's automatic acceleration of debts were to defeat a YMP, no YMP would ever be enforceable in bankruptcy. Such a rule would permit a borrower to “avoid the effect of a prepayment premium by filing a bank-

64. *Id.*

65. *Id.* at 332.

66. 85 B.R. 160 (Bankr. M.D. Fla. 1988).

67. *Id.* at 162.

68. *Pub. Serv.*, 114 B.R. at 816.

69. *LHD Realty*, 726 F.2d at 331 (7th Cir. 1984). See also *In re Duralite Truck Body & Container Corp.*, 153 B.R. 708 (Bankr. D. Md. 1993) (creditor prompted prepayment by its collection efforts: when a lender exercises its option to accelerate upon default, the economic justification for a prepayment premium as alternative performance of the bargained loan is negated.); *Planvest Equity Income Partners IV*, 94 B.R. at 645 (it is questionable whether creditor is entitled to YMP when it sought to lift automatic stay).

70. 11 U.S.C. § 502(b)(1) (2000).

71. *Skyler Ridge*, 80 B.R. 500.

ruptcy case. Neither the Bankruptcy Code nor case law compels the invalidation of a properly drawn premium clause in all cases."⁷²

Today, the question of waiver seems to be a non-starter. Presumably after the waiver case law churned out, *prepayment* penalties underwent a name change. They morphed into yield maintenance premiums that became due upon acceleration. That way, acceleration would trigger rather than nullify the lender's right to receive compensation for interest lost.

V. A YMP'S ENFORCEABILITY IN BANKRUPTCY

A. YMPs and Sections 502(b)(1) and 506(b): Overview

Section 502(b)(1) generally disallows claims that are not enforceable under applicable nonbankruptcy law.⁷³ Section 502(b)(1)'s policy seems obvious. Why should bankruptcy recognize a creditor's right to payment when applicable nonbankruptcy law does not?⁷⁴ Some courts do not evaluate a YMP's enforceability under section 502(b)(1) and applicable nonbankruptcy law.⁷⁵ Apparently, those courts have impliedly concluded that section 506(b) states a federal standard of reasonableness, independent of state law, and therefore, no analysis under applicable nonbankruptcy law, e.g., state law, is necessary. Such a conclusion requires closer scrutiny.

Section 506(a) defining "secured claim" provides: "an *allowed claim* of a creditor secured by a lien in which the estate has an interest . . . [is] a *secured claim* to the extent of the value of such creditor's interest in the estate's interest in such property . . . and [is] an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim."⁷⁶ According to one court, "unless there is an underlying right to payment under non-bankruptcy law, there is no allowed secured claim under . . . [section] 506(b)."⁷⁷ Section 506(a) seems to suggest that a creditor cannot have an allowed *secured claim* unless it has an *allowed claim*. A creditor cannot have an allowed claim unless it files a proof of claim under section 501 and

72. *Id.* at 507.

73. 11 U.S.C. § 502(b)(1) (2000) disallows a claim "to the extent that — (1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmaturing . . .". 11 U.S.C. § 502(b)(1) (2000).

74. Unmatured claims and contingent claims are the exception to the exception. Bankruptcy does recognize them, i.e., they *are* allowable in bankruptcy even though they would not be enforceable under applicable nonbankruptcy law. 11 U.S.C. § 502(b)(1) (2000).

75. See, e.g., *Duralite Truck Body & Container*, 153 B.R. 708.

76. 11 U.S.C. § 506(a) (2000).

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

it is deemed allowed, or the court, after objection, allows it under section 502. Are courts mistaken then when they do not stop at section 502 but instead go directly to section 506 to analyze the enforceability of a YMP? Maybe not, even though a creditor cannot have an allowed secured claim unless it has an allowed claim under section 502.

A YMP analysis under section 506 involves section 506(b). Section 506(b) appears to discuss an oversecured creditor's situation *postpetition*. According to section 506(b), an oversecured creditor's claim can include postpetition interest and "any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."⁷⁸ Although the statute is not explicit, one could easily conclude section 506(b)'s reference to "fees, costs and charges provided for under the agreement" also refers to *postpetition* fees, costs and charges. But, at least one court has said section 506(b) applies to *prepetition* as well as postpetition fees, costs and charges.⁷⁹ Other courts, by analyzing a *prepetition* YMP claim under section 502, think otherwise.⁸⁰ It is also possible to characterize a YMP that only comes due postpetition as a contingent right to payment as of the petition date.⁸¹ Therefore, section 502 would initially govern its enforceability.

The case law here is inconsistent in the extreme. Courts go every which way, half the time not explaining why they went where they went and why they did not go somewhere else. What follows are the basic analytical approaches courts have taken to test the enforceability of a YMP in bankruptcy.

B. *Forward "Two-Step" Approach: First Section 502, Then Section 506*

According to some courts, evaluation of a YMP's enforceability involves a two-step process. First, the court must consider its enforceability under applicable state law. If state law would give it effect, the court will proceed to section 506(b) to determine if it is reasonable.⁸²

In *Noonan v. Fremont Financial (In re Lappin Electric Co.)*,⁸³ the creditors had filed an involuntary chapter 7 against the debtor. The debtor's assets were sold to a third party and Fremont Financial was

78. 11 U.S.C. § 506(b) (2000).

79. *In re Center*, 282 B.R. 561 (Bankr. D.N.H. 2002).

80. *Hidden Lake*, 247 B.R. 722.

81. In *In re Keaton*, 182 B.R. 203 (Bankr. E.D. Tenn. 1995), the court characterized an undersecured creditor's right to postpetition attorney's fees as a contingent right to attorney's fees as of the petition date and therefore allowable as part of its claim. *Id.* at 210.

82. See, e.g., *Skyler Ridge*, 80 B.R. 500; *Kroh Bros.*, 88 B.R. at 1001 (YMP is unenforceable under Missouri law and unreasonable under § 506(b)).

83. 245 B.R. 326 (Bankr. E.D. Wis. 2000).

paid its full secured claim of over \$ 4 million, including a “prepayment fee” of \$225,000.⁸⁴ The chapter 7 trustee brought an adversary proceeding against Fremont to recover the \$225,000 prepayment fee for the estate.⁸⁵ The trustee argued the secured creditor had suffered no actual loss, and therefore, the fee was unreasonable under section 506(b).⁸⁶ The secured creditor countered that the fee was reasonable under both state law and section 506(b).⁸⁷

The court refused to jump straight into section 506(b). Instead, it adopted a “two-pronged approach” to determine the fee’s reasonableness.⁸⁸ First, the YMP had to be valid at state law. And, if valid at state law, it also had to be a reasonable charge under section 506(b).⁸⁹ If the fee was unenforceable at state law, the court would disallow it under section 502(b)(1).⁹⁰ Even if enforceable at state law, section 506(b) would disallow it if it was unreasonable.⁹¹

Turning to the first prong, the court looked to Illinois stipulated damages law.⁹² The court concluded that “[t]aken as a whole, the termination fee . . . is a reasonable calculation of potential damages, and it meets the requirements of Illinois law.”⁹³

Turning to the second prong, the court noted that bankruptcy courts were split over what section 506(b)’s reasonableness requirement entailed.⁹⁴ According to one line of cases, section 506(b) limits a creditor’s recovery to *actual* costs, charges, and fees.⁹⁵ Although the court found the concept of limiting recovery to actual damages “attractive,” that formula was impossible to apply in a line of credit situation.⁹⁶ Following another line of cases, the court tested the reasonableness of the prepayment charge using a liquidated damages analysis.⁹⁷ The court found the fee reasonable under section 506(b).⁹⁸ Although the court seemed to assume a federal liquidated damages standard governed its analysis, it would have reached the same result had it

84. *Id.* at 328.

85. *Id.*

86. *Id.* at 329.

87. *Id.*

88. *Lappin*, 245 B.R. at 329.

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Lappin*, 245 B.R. at 330.

94. *Id.*

95. *Id.* (collecting cases).

96. *Id.*

97. *Id.* at 330-31 (collecting cases).

98. *Lappin*, 245 B.R. at 331.

used a state standard in applying section 506(b)'s reasonableness requirement.

In *Lappin*, the lender's right to a YMP arose postpetition. In *In re AE Hotel Venture*,⁹⁹ the lender's YMP claim arose prepetition, but the court applied the same two-pronged approach.¹⁰⁰ In *AE Hotel*, the debtor had defaulted prepetition and the lender sought judicial foreclosure six months later.¹⁰¹ Three days after the lender filed in state court, the debtor sought chapter 11 protection.¹⁰² The property was sold, and the lender requested late fees,¹⁰³ default interest and a prepayment premium under sections 506(a) and (b).¹⁰⁴

The court summarily disposed of the lender's claim for default interest (5% above the contract rate).¹⁰⁵ The court characterized the claim as a charge, rather than interest, and concluded it was not reasonable under section 506(b).¹⁰⁶ The lender had already received late charges.¹⁰⁷ Recovering default interest would have compensated it twice for a single injury. It could receive late charges or default interest, but not both.¹⁰⁸

The court then turned to the YMP. It applied the same two-pronged test.¹⁰⁹ The YMP had to be enforceable under state law *and* reasonable under section 506(b).¹¹⁰ Whether a charge was reasonable was, "of course, a question of federal law."¹¹¹ Applying Illinois liquidated damages law, the court had no problem finding the premium enforceable.¹¹² The court also quickly disposed of the debtor's argument that the premium was not "provided for under the agreement."¹¹³ It was, and that was that.¹¹⁴ Because the debtor did not question the reasonableness of the prepayment premium,¹¹⁵ the court

99. 321 B.R. 209 (Bankr. N.D. Ill. 2005).

100. *Id.*

101. *Id.* at 214.

102. *Id.*

103. The debtor did not object to the late fees. *Id.* at 215.

104. *AE Hotel Venture*, 321 B.R. at 214.

105. *Id.* at 215.

106. *Id.* at 216.

107. *Id.*

108. *Id.*

109. *AE Hotel Venture*, 321 B.R. at 217.

110. *Id.*

111. *Id.*

112. *Id.* at 219-20.

113. *Id.* at 217-18

114. *AE Hotel Venture*, 321 B.R. at 217-18.

115. *Id.* (it only questioned whether the YMP was "provided for under the agreement" and whether it was enforceable under state law).

did not need to reach the “difficult question” of the proper federal standard for reasonableness under section 506(b).¹¹⁶

In *Ferrari v. Barclays American/Business Credit, Inc. (In re Morse Tool, Inc.)*,¹¹⁷ the lender and the chapter 7 trustee had filed cross-motions for summary judgment to determine the YMP’s enforceability.¹¹⁸ The court did not reach the ultimate issue because the existence of several genuine issues of material fact made summary judgment inappropriate.¹¹⁹ Nevertheless, the court took the opportunity to set out its analytic structure for deciding the issue. First, the court would evaluate the YMP’s enforceability at state law pursuant to section 502(b)(1).¹²⁰ If enforceable at state law, it would consider the YMP’s reasonableness under section 506(b).¹²¹ Although the court did not decide if the YMP was enforceable, it staked out its position. It would hold the YMP reasonable under section 506(b) only if it provided for “actual and necessary damages.”¹²² Therefore, even if the YMP met Connecticut standards for liquidated damages, the lender would still have to prove its actual loss as a result of prepayment.¹²³

C. Section 502 Alone Governs YMPs that Become Due Prepetition

*In re Leatherland Corp.*¹²⁴ involved a “success fee.”¹²⁵ The creditors’ committee maintained the “success fee” was unreasonable, both because it was an invalid penalty under state law, and because it was unreasonable under section 506(b).¹²⁶ The secured creditor countered that the success fee was not a “fee” within the meaning of section

116. *Id.* at 221. The court noted two lines of cases. The first, which it characterized as the majority, limits recovery to the actual damages the creditor suffered from the prepayment. *Id.* These courts also often “examine the equities” of awarding the premium. *Id.* The minority view evaluates prepayment premiums as liquidated damages clauses. *Id.* n.10 (collecting cases).

117. 87 B.R. 745 (Bankr. D. Mass. 1988).

118. *Id.*

119. *Id.* at 751 (the court concluded it did not have sufficient information to decide whether the YMP was enforceable under Connecticut law or what the creditor’s actual damages were).

120. *Id.* at 748.

121. *Id.*

122. *Morse Tool*, 87 B.R. at 750.

123. *Id.*

124. 302 B.R. 250 (Bankr. N.D. Ohio 2003).

125. *Id.* This was a payment

equal to two percent of the highest principal sum due under the note during the period from May 31, 2002, to January 31, 2003. The . . . “Success Fee” [would have been] waived if by December 31, 2002, and January 31, 2003, the outstanding principal amount due is reduced as required in the agreement.

Id. at 252-53.

126. *Id.* at 253.

506(b) and therefore, it was not subject to a reasonableness determination.¹²⁷

The court first examined “whether an oversecured creditor’s claim for a fee that matured *prepetition* is subject to the section 506(b) reasonableness standard.”¹²⁸ It noted that the courts, relying on section 506(b)’s plain meaning, disagreed on whether section 506(b) applied to *prepetition* as well as *postpetition* fees, charges, etc.¹²⁹

The court’s own examination of section 506(b)’s plain language led it to agree with those courts that concluded it only applied to fees that accrued *postpetition*.¹³⁰ The court noted a contrary conclusion could lead to absurd results:

For example, if a secured creditor is undersecured by one dollar, [section] 506(b) does not apply and the creditor has an allowed claim that includes all *prepetition* fees and charges that are enforceable against the debtor and property of the debtor under its agreement or applicable law. . . . No additional reasonableness determination need be made. But if the secured creditor is oversecured by one dollar, the same *prepetition* fees and charges may not be allowed after subjecting them to the [section] 506(b) reasonableness standard. . . . The Court does not believe that Congress intended such an anomalous result. Rather, the purpose of [section] 506(b) is to permit a creditor to collect certain *postpetition* additions from the collateral securing its claim only to the extent that it is oversecured.¹³¹

Therefore, the court had to determine whether the *prepetition* success fee was part of the lender’s allowed claim under section 502(b).¹³² The court assumed it had to allow the success fee under section 502(b)(1) if it was enforceable against the debtor “under any agreement or applicable law. . . .”¹³³ Moreover, the court agreed with the creditors’ committee that Ohio’s liquidated damages rules were the applicable law.¹³⁴

On the merits, the court performed a close examination of Ohio liquidated damages law.¹³⁵ In the end, it concluded “the Success Fee” provision is, and was intended to be, nothing more than a penalty for

127. *Id.*

128. *Id.* at 256.

129. *Leatherland*, 302 B.R. at 256-58 (collecting cases).

130. *Id.* at 258.

131. *Id.*

132. *Id.* at 257.

133. *Id.* at 259 (citing 11 U.S.C. § 502(b)(1)).

134. *Leatherland*, 302 B.R. at 259.

135. *Id.* at 259-64.

failure to pay down the principal balance."¹³⁶ Therefore, it was not part of the creditor's allowed claim.¹³⁷

The court in *In re Hidden Lake L.P.*¹³⁸ also relied exclusively on section 502 to evaluate the enforceability of a \$2,699,487 YMP.¹³⁹ Like *Leatherland*, it involved application of Ohio stipulated damages law. The court noted recognition of the YMP would potentially overcompensate the lender.¹⁴⁰ It would also complicate the debtor's attempt to reorganize.¹⁴¹ Nevertheless, a careful examination of Ohio law required it to conclude the YMP was a valid liquidated damages clause rather than a penalty.¹⁴² The debtor also argued that the YMP was a claim for unmatured interest and barred by section 502(b)(2).¹⁴³ The court considered but rejected this argument because the lender's entitlement to the YMP arose on its acceleration of the debt, and hence it had matured long before the debtor filed for chapter 11 relief.¹⁴⁴

D. Section 506(b) Alone Governs a YMPs Enforceability

According to some courts, section 506(b) alone controls a YMP's validity and enforceability.¹⁴⁵ Within that camp, courts divide on whether "reasonableness" is determined under a federal or state standard.¹⁴⁶

1. The Proper Standard Is a Federal One

Although it focuses on the treatment of attorney's fees rather than YMPs under section 506(b), *Unsecured Creditors' Committee v. Walter E. Heller & Co. (In re K.H. Stephenson Supply Co.)*¹⁴⁷ provides an excellent summary of section 506(b)'s legislative history. In *Stephenson*, the bankruptcy court had awarded oversecured creditor Walter E. Heller and Co. ("Heller") attorney's fees pursuant to its agreement with the debtor. The district court reversed, holding Congress had intended that state law govern enforceability and Heller had failed to

136. *Id.* at 264.

137. *Id.*

138. 247 B.R. 722 (Bankr. S.D. Ohio 2000).

139. *Id.*

140. *Id.* at 728.

141. *Id.*

142. *Id.* at 728-30.

143. *Hidden Lake*, 247 B.R. at 730.

144. *Id.*

145. See, e.g., *Duralite Truck Body & Container*, 153 B.R. 708 (although New York liquidated damages law would likely enforce YMP, state law is not controlling under section 506(b)).

146. *Morse Tool*, 87 B.R. 745.

147. 768 F.2d 580 (4th Cir. 1985).

comply with state notice requirements. The Fourth Circuit agreed with Heller that federal law controlled. It reversed the district court and remanded to the bankruptcy court to determine if Heller's fees were reasonable.

The Fourth Circuit provided an exhaustive analysis of section 506(b)'s legislative history, indicating that Congress intended to make agreements regarding attorney's fees enforceable in bankruptcy even though state law would deny them effect.¹⁴⁸ For those interested, we include the entire discussion in a footnote.¹⁴⁹

148. *Id.* at 585.

149. "The relevant legislative history of section 506(b) began in the House Judiciary Committee. When the House's version of the Bankruptcy Reform Act, H.R. 8200, was referred to the committee, section 506(b) read as follows:

To the extent that an allowed secured claim is secured by property whose value is greater than the amount of such claim, there shall be allowed to the holder of such claim interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose.

H.R. 8200, 95th Cong., 1st Sess. § 506(b) (July 11, 1977), accompanying H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977); reprinted in N. Resnick & E. Wypyski, *12 Bankruptcy Reform Act of 1978: A Legislative History*, doc. 41 at 79 (1979). H.R. 8200 was amended in committee. One of the changes was an addition to section 506(b) which read, in part, that "there shall be allowed to the holder of such claim to the extent collectible under applicable law interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose." H.R. 8200, 95th Cong., 1st Sess. § 506(b) (Sept. 8, 1977); reprinted in Resnick & Wypyski, *supra*, vol. 12, doc. 41 at 387 (emphasis added). In the report accompanying H.R. 8200, the House Judiciary Committee explained that:

Subsection (b) *codifies current law* by entitling a creditor with an oversecured claim to any reasonable fees, costs, or charges provided under the agreement under which the claim arose. These fees, costs, and charges are secured claims to the extent that the value of the collateral exceeds the amount of the underlying claim.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 356-57 (1977) (emphasis added). When the House first passed H.R. 8200 on February 1, 1978, section 506(b) remained in the form in which it had come out of the Judiciary Committee. 124 Cong.Rec. 1, 783-1,804 (1978).

On October 31, 1977, the Senate version of the Bankruptcy Reform Act was introduced and referred to the Senate Judiciary Committee. 123 Cong. Rec. 36,095 (1977). The Senate version of section 506(b) was almost identical to the initial House version. It provided that:

To the extent that an allowed secured claim is secured by property, the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, any reasonable fees, costs, or charges provided under the agreement under which such claim arose.

S. 2266, 95th Cong., 1st Sess. § 506(b) (Oct. 31, 1977); reprinted in Resnick & Wypyski, *supra*, vol. 14, doc. 46 at 86. Senator DeConcini, a member of the Senate Judiciary Committee and co-author of the bill, explained in an accompanying report that section 506(b)

codifies current law by entitling a creditor with an oversecured claim to any reasonable fees (including attorney's fees), costs, or charges provided under the agreement under which the claim arose. These fees, costs, and charges are [sic] secured claims to the extent that the value of the collateral exceeds the amount of the underlying claim.

S. Rep. No. 95-989, 95th Cong., 1st Sess. 68 (1977) (emphasis added). Section 506(b) remained unchanged as S. 2266 was reported out of both the Senate Judiciary Committee and the Finance

One does not have to adopt *Stephenson's* position that section 506(b) enforces fees that are unenforceable at state law to accept its

Committee. S. 2266, 95th Cong., 2d Sess. § 506(b) (July 14 and Aug. 10, 1978); *reprinted in* Resnick & Wypyski, *supra*, vol. 17, doc. 53 at 82-83 and 394; *see* 124 Cong. Rec. 25,305 (1978).

Until early October of 1978, both Houses of Congress continued active consideration of the Bankruptcy Reform Act amid controversy regarding the Article III status of bankruptcy judges. Klee, 28 DEPAUL L.REV. 941, 952-56. As the 95th Congress was drawing to a close, substantial differences remained between the House and Senate versions of the Act. *Id.* at 953-54. One of those differences was in section 506(b). The House version retained the explicit requirement that state law determine the enforceability of attorney's fee agreements. The Senate version contained no such language.

The differences between the House and Senate versions of the Act were resolved by the managers of the legislation without a formal conference in late September of 1978. Klee, 28 DEPAUL L.REV. at 953-54. As an apparent substitute for a formal conference report, Edwards and DeConcini reported on the compromise bill to their respective Houses of Congress. Using identical language, they explained that the House version had been rejected and the Senate version retained and that, as a result, attorney's fee agreements would be enforceable "notwithstanding contrary law." 124 Cong. Rec. 32,398, 33,997 (1978). The Bankruptcy Reform Act, in its final form, passed the Senate on October 5, 1978, 124 Cong. Rec. 33,989-34,019 (1978), and the House on the following day. 124 Cong. Rec. 34, 143-45 (1978).

The confusion that results from the legislative history of section 506(b) arises from the fact that early on in the legislative process both the House and Senate versions of the Act were described as codifying current law, even though the two versions contained different language. *Compare* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 356-57 (1977) *with* S. Rep. No. 95-989, 95th Cong., 1st Sess. 68 (1977). Later the Senate Bill was interpreted as having a contrary meaning even though the Senate language remained the same. *Compare* S. Rep. No. 95-989, 95th Cong., 1st Sess. 68 (1977) *with* 124 Cong. Rec. 33,997 (1978) (remarks of Senator DeConcini).

This confusion can be resolved through an examination of the fate of the House version of the bill. The House language that fee agreements "shall be allowed . . . to the extent collectible under applicable law" was added to section 506(b) by the House Judiciary Committee. The Committee clearly believed such language was needed in order to explicitly retain the state law requirement. When this version of section 506(b) was initially passed by the entire House, it was with the understanding that the state law requirement would be retained.

When the Bankruptcy Reform Act neared the end of the legislative process in September of 1978, two versions of section 506(b) remained. By this point the Senate had had the opportunity to fine tune many aspects of its version of the bill. *See* Klee, 28 DEPAUL L. REV. at 949-955. Although the Senate had ample opportunity to adopt the language of the House version, it refused to do so. Instead, in the final negotiations which resulted in the compromise bill, *see* Klee, 28 DEPAUL L. REV. at 953-54, the Senate insisted on its version. The Senate explicitly rejected the House language and the House agreed to this significant change. The explicit rejection of the House language by both Houses of Congress is a clear indication that, under the final version of the Bankruptcy Reform Act, Congress intended that state law should no longer govern the enforceability of attorney's fee agreements. If Congress had desired to retain this pre-existing requirement, it had the means at its disposal in the form of the House language. That Congress chose to reject that language is an indication that Congress chose to reject the pre-existing law. The statements of Representative Edwards and Senator DeConcini that, under the final version of the Act, fee agreements are enforceable "notwithstanding contrary law," 124 Cong. Rec. 32,389, 33,997 (1978), consequently reinforce an interpretation of congressional intent behind section 506(b) which is apparent from the legislative process itself.

In sum, we conclude that, in rejecting the House version of section 506(b), Congress intended to abrogate the pre-existing requirement that attorney's fee agreements were enforceable only in accordance with state law. Such agreements are now enforceable notwithstanding contrary law." *K.H. Stephenson Supply*, 768 F.2d at 582-85.

more prosaic conclusion that federal law should supply section 506(b)'s reasonableness standard. Although *Stephenson* dealt with attorney's fees rather than a YMP, section 506(b) imposes a "reasonableness" requirement on all "fees, costs, or charges." It therefore makes sense to apply a federal reasonableness standard to YMPs as well. That is the conclusion reached in *In re A.J. Lane & Co.*¹⁵⁰ In *A.J. Lane*, Judge Queenan examined whether state or federal law governed a YMP's reasonableness. He framed the question as "whether the standard of reasonableness mandated by [section] 506(b) requires federal courts to fashion their own rules governing what charges are reasonable, unrestrained by state law."¹⁵¹

According to Judge Queenan, under the Act, state law governed the enforceability of such provisions.¹⁵² However, the Act did not impose an express requirement of reasonableness on a creditor's right to recover fees, charges and costs.¹⁵³ "Section 506(b) does, and this requirement alone indicates an intention to impose a single, federal standard."¹⁵⁴ He went on to note that state law generally governs claims but administrative expenses require special scrutiny because they are paid before all other unsecured claims. The Code only grants administrative expense status to actual, necessary costs and expenses of preserving the estate.¹⁵⁵ Among administrative expenses are attorney's fees. Section 330(a) only allows *reasonable* attorney's fees. No one would argue for anything other than a single federal standard there:

The protection of general creditors from unreasonable fees enjoying first priority is central to the bankruptcy policy favoring a fair distribution to creditors. Yet this policy applies with even greater force to charges under [section] 506(b). The claim of a secured creditor to his collateral is of course senior to that of even a first priority claimant such as an attorney rendering services to the estate. It would make no sense to interpret "reasonable" as it appears in [section] 506(b) according to state law while applying a federal standard to "reasonable" under [section] 330(a)(1) governing attorney's fees.¹⁵⁶

2. YMPs Must Satisfy State and Federal Law

Section 506(b)'s legislative history has not persuaded all courts to interpret section 506(b) as trumping state law. In *Ferrari v. Barclays*

150. 113 B.R. 821 (Bankr. D. Mass. 1990).

151. *Id.* at 823.

152. *Id.* at 823-24, (citing *Security Mortgage Co. v. Powers*, 278 U.S. 149, 153-54 (1928)).

153. *A.J. Lane*, 113 B.R. at 824.

154. *Id.*

155. *Id.*

156. *Id.*

American/Business Credit, Inc. (In re Morse Tool, Inc.),¹⁵⁷ the court rebuffed the argument that a charge could be valid under section 506(b) even if it was unenforceable under state law.¹⁵⁸ Judge Kenner acknowledged that, read alone, section 506(b) appeared "to override any contrary state law regarding the validity of the charges."¹⁵⁹ On its face, section 506(b) only states three conditions for allowing a claim: (1) the claim had to be oversecured; (2) the charge had to be reasonable; and (3) the charge had to be provided for under the agreement that gave rise to the claim. Section 506(b) nowhere expressly requires the charge to be enforceable under state law.¹⁶⁰

Nevertheless,

section 506(b), however, does not stand alone. It must be read in conjunction with the remainder of the Bankruptcy Code. As a general rule, the Code requires that the validity of claims be determined according to non-bankruptcy law. The Code defines a "claim" as a "right to payment," 11 U.S.C. § 101(4), and requires the Court, upon objection, to disallow claims to the extent that they are unenforceable "under any agreement or applicable law." 11 U.S.C. § 502(b)(1).¹⁶¹

According to Judge Kenner, section 506(b) does not expressly override the Code's general policies nor the specific sections cited. It is therefore possible to construe it one of two ways. Either section 506(b) creates an implicit exception to the general rule that state law governs the validity of claims *or* section 506(b) supplements that rule.¹⁶² Judge Kenner thought the latter was the better interpretation.

In her view, the statute's language was unambiguous. She therefore saw no need to go to legislative history, especially because it depended so heavily on the floor statements of two of the bill's managers.¹⁶³ Judge Kenner concluded:

No court should look behind an unambiguous statute for a contrary intent because, by using the contrary intent as a guide, the court

157. 87 B.R. 745 (Bankr. D. Mass. 1988).

158. *Id.* at 749. *Stephenson and Joseph F. Sanson Investment Co. v. 268 Limited (In re 268 Limited)*, 789 F.2d 674 (9th Cir. 1986), which relied on the same legislative history to reach the same conclusion, both dealt with attorney's fees. There seems general agreement that the principle of those cases would also apply to YMPs. Judge Kenner certainly made that assumption in *Morse Tool*. She did not simply dismiss the argument as inapplicable to YMPs.

159. *Morse Tool*, 87 B.R. at 748.

160. *Id.*

161. *Id.*

162. *Id.*

163. She quoted Representative Edwards and Senator De Concini as saying, "[i]f the security agreement between the parties provides for attorney's fees, it will be enforceable under title 11 notwithstanding contrary law." *Id.* at 749 (quoting 124 Cong. Rec. H11095 (daily ed. September 28, 1978) (emphasis added) and 124 Cong. Rec. S17411 (daily ed. October 6, 1978)).

would be favoring the unenacted history over the statute itself. Therefore, the plainer the language of the statute, the more convincing the contrary legislative history must be to overcome it. . . . In this case, the statute (sections 101(4), 502(b)(1) and 506(b) of the Bankruptcy Code) is relatively clear; its ambiguity can be eliminated with rudimentary principles of statutory interpretation, as was demonstrated above. The legislative history, on the other hand, is unconvincing and less reliable than the statute itself.¹⁶⁴

E. *Is the YMP a Reasonable Charge under Section 506(b)?*

1. A Valid Liquidated Damages Clause Is Reasonable

Whether the court evaluates a YMP's effectiveness at state law or under a federal standard of reasonableness pursuant to section 506(b), many courts apply a traditional "stipulated damages" analysis.¹⁶⁵ Under that analysis, the damages stipulated in the contract are enforceable only if (1) they represent a reasonable forecast of just compensation for the harm caused by breach, and (2) the harm is difficult to estimate.¹⁶⁶

Courts undertaking a stipulated damages analysis often begin by establishing the YMP's function.

The usual purpose . . . is to assure that the lender will receive the contractual rate of return for the life of the loan, or the equivalent thereof. Such a clause provides protection to a lender against a downturn in interest rates, which would permit the borrower to refinance the mortgage at a lower interest rate, and thereby deprive the lender of its unearned interest over the unexpired portion of the loan.¹⁶⁷

Courts identify the function of the YMP to determine what damages it is seeking to capture. Courts have invalidated them when their formula for calculating damages fails to discount to present value or is pegged to the interest rate for United States treasury notes.¹⁶⁸

What is the matter with calculating a lender's damages based on the difference between the contract interest rate and the interest rate of treasury bonds? As the court in *Kroh Brothers* explained, the lender

164. *Id.*

165. See, e.g., *Kroh Bros.*, 88 B.R. at 999 (if clause is valid and enforceable as liquidated damages clause under state law, it is also valid and enforceable in bankruptcy); *A.J. Lane*, 113 B.R. at 827 (prepayment charge is provision for liquidated damages and governed by rules applicable to such).

166. See, e.g., *Kroh Bros.*, 88 B.R. at 999; *A.J. Lane*, 113 B.R. at 828; *Fin. Ctr. Assocs.*, 140 B.R. at 835; but see *Skyler Ridge*, 80 B.R. at 503 (classification of prepayment premium language as liquidated damages provision is not altogether certain but parties have agreed upon this characterization and court accepts it).

167. *Skyler Ridge*, 80 B.R. at 504-505.

168. See, e.g., *Skyler Ridge*, 80 B.R. at 505; *Kroh Bros.*, 88 B.R. at 1000.

before it as well as the lender in *Skyler* typically invested in first mortgages. Mortgages have much higher interest rates than treasury bonds. Pegging the lender's loss to treasury bonds would overcompensate the lender. The lender would receive a windfall because it would reinvest in first mortgages not treasury bonds.¹⁶⁹ The court observed that it would have found that particular feature of the formula reasonable had the contract provided some means for adjusting the formula to reflect the lender's rate of reinvestment.¹⁷⁰ The court also found the YMP wanting because it failed to provide a discount to present value.¹⁷¹ In short, the YMP was an unreasonable forecast of damages. It was disproportionate to the amount of probable damages caused and it was oppressive to the debtor.¹⁷² (Other than that, though, it was great.)

Generally, the enforceability of a stipulated damages clause comes into question when the damages the aggrieved party actually suffers are significantly less than the damages stipulated in the contract. The question creates an intractable conflict between two key goals of contract law: compensation (not overcompensation) for losses suffered and freedom of contract. Just like courts outside the bankruptcy arena, courts within it have different views on which policy should prevail. In *Financial Center Associates v. The Funding Corp. (In re Financial Center Associates)*,¹⁷³ the court came down resoundingly on the side of freedom of contract. The court expressly rejected *Skyler*¹⁷⁴ because the *Skyler* court limited the parties' freedom of contract. In *Skyler*, the court substituted its own judgment regarding the appropriate discount rate for that of the parties.¹⁷⁵ That was objectionable:

The magnitude of the loan transaction and quality and quantity of the loan documents leave little doubt that . . . we have an arms-length transaction between adequately represented sophisticated businessmen Under these circumstances, we feel . . . that it would be offensive to the basic notion of freedom of contract if the Debtor's arguments were to prevail. Were we to accept Debtor's position we would be granting borrowers a license to gamble with Lenders' money regarding the discount rate applicable to pre-payment charges, a gamble that cannot fail: should the yield on Treasury Bonds go up, the Debtor honors the deal; if, however, the yield goes down, the Debtor moves to invalidate the pre-payment charge.

169. *Kroh Bros.*, 88 B.R. at 1000.

170. *Id.*

171. *Id.* at 1001.

172. See also *Skyler Ridge*, 80 B.R. 500.

173. 140 B.R. 829, 835 (Bankr. E.D.N.Y. 1992).

174. *Skyler Ridge*, 80 B.R. 500.

175. *Fin. Ctr. Assocs.*, 140 B.R. at 837.

Such a result offends our sense of fair play. . . . It is an attempt to soften the blow of a bad business judgment. The purpose of chapter 11, whether under the old Act or under the Bankruptcy Code, has never been designed to absorb the consequences of risk taking.¹⁷⁶

Whether the stipulated damages analysis is characterized as state or federal, the analysis itself is sufficiently flexible to permit courts to reach whatever result they choose. The happenstance of bankruptcy does not alter that reality.

In *A.J. Lane*,¹⁷⁷ Judge Queenan measured the YMP by a federal standard of liquidated damages. In characteristic fashion, his opinion discusses the treatment of YMPs beginning with Adam and Eve. He noted that courts as early as 1829 treated prepayment of an installment contract as a breach of contract absent a contract clause permitting prepayment.¹⁷⁸ The prepayment charge is a natural result of viewing prepayment as a breach. A YMP represents the parties' attempt to fix damages for that breach.¹⁷⁹

Judge Queenan went on to test the YMP using traditional contract principles. He found it wanting on two counts. First, the amount fixed was unreasonable in light of both the anticipated and the actual loss. The YMP presumed the creditor would suffer damages and those damages would "equal lost interest income of one percent for the balance of the loan."¹⁸⁰ According to Judge Queenan, it was unreasonable to presume a loss. Economic conditions are not static. It was just as likely that interest rates would go up as down.¹⁸¹ Therefore, the YMP was unreasonable in light of the anticipated loss. It was also unreasonable in light of the lender's actual loss. The lender did not suffer a loss. In fact, the creditor had benefitted from the prepayment because interest rates had gone up.¹⁸²

The YMP also failed the second test. The damages were not difficult to estimate. The only substantial loss a lender can incur is a loss of interest income when reinvesting the funds.¹⁸³ Such a loss is measured by a simple and well-established formula: "it is the difference in the interest yield between the contract rate and the market rate at the

176. *Id.* at 837-38.

177. *A.J. Lane*, 113 B.R. 821.

178. *Id.* at 827.

179. *Id.*

180. *Id.* at 829.

181. "And this is precisely what happened." *Id.*

182. *A.J. Lane*, 113 B.R. at 829.

183. *Id.*

time of prepayment, projected over the term of the loan and then discounted to arrive at present value."¹⁸⁴

2. Only Actual Damages Are Reasonable

A.J. Lane seems to hold that a YMP is not reasonable under section 506(b) unless it captures the lender's actual damages.¹⁸⁵ Other courts have made explicit what seems implicit in *A.J. Lane*.¹⁸⁶ For instance, in *In re Outdoor Sports Headquarters*,¹⁸⁷ the court wrote:

In light of the economic rationale underlying prepayment charges, the court finds that "reasonable" charges under [section] 506(b) are those that compensate the lender for the harm caused by the prepayment, the amount of actual damages which result from the prepayment.¹⁸⁸

The court in dictum in *Ferrari v. Barclays American/Business Credit, Inc. (In re Morse Tool, Inc.)*¹⁸⁹ agreed, stating a YMP would be reasonable under section 506(b) only if it was "actual and necessary."¹⁹⁰ Therefore, even if the YMP met Connecticut standards for liquidated damages, the creditor would still have to prove its actual loss.

184. *Id.*

185. Although *A.J. Lane* seems to require a showing of actual harm, it is often listed as in the minority of cases that apply a liquidated damages analysis. See, e.g., *AE Hotel Venture*, 321 B.R. at 217 (collecting cases).

186. One recent opinion concludes that a majority of court apply an actual harm standard. See *AE Hotel Venture*, 321 B.R. at 217 (collecting cases).

187. 161 B.R. 414 (Bankr. S.D. Ohio 1993).

188. *Id.* at 424. See also *Imperial Coronado Partners*, 96 B.R. at 1001 (YMP is part of creditor's claim but creditor was not entitled to full premium in bankruptcy even if it was entitled to it at state law because creditor under section 506(b) is only entitled to actual damages measured by difference between (1) market rate of interest on prepayment date, and (2) the contract rate, for the remaining term); *Kroh Bros.*, 88 B.R. at 1001 (YMP was unreasonable under section 506(b) because it was an unreasonable forecast of damages, it was disproportionate to amount of probable damages suffered, it was oppressive to debtor, and it did not account for higher interest rates at the time of prepayment which could result in a windfall to the creditor: Section 506(b)'s requirement of "reasonable" requires actual costs, charges and fees meaning a YMP is only reasonable if it provides for a creditor's actual damages); *Duralite Truck Body & Container*, 153 B.R. at 719-20 ("This court approves of actual damages as the measure of reasonableness for prepayment charges under section 506(b)" and creditor's ability to prove actual damages was unlikely given that the interest rate was a floating rate based on prime); *Planvest Equity Income Partners IV*, 94 B.R. at 645 (YMP is not reasonable fee under section 506(b) because creditor failed to show YMP in excess of \$300,000 was actual or reasonable cost resulting from prepayment of loan).

189. 87 B.R. 745 (Bankr. D. Mass. 1988).

190. *Id.* at 750.

F. *Backward "Two-Step" Approach: First Section 506, Then Section 502*

Georgia law allows contracts to provide for attorney's fees of up to fifteen percent.¹⁹¹ The fees provided for are recoverable whether earned or not if the creditor gives the borrower ten days notice. In *Welzel v. Advocate Realty Investments, LLC (In re Welzel)*,¹⁹² the debtor had signed several notes agreeing to fifteen percent attorney's fees. The debtor defaulted, the lender gave the required notice, and the debtor filed for chapter 11 relief after the ten-day notice period had expired.

The lender filed a secured proof of claim for \$1,125,464.47, including \$146,799.71 representing attorney's fees.¹⁹³ The lender argued it was entitled to the fees because they had vested prepetition under state law. The debtor maintained the fees were unreasonable under section 506(b) and asked the court to disallow them.

The bankruptcy court concluded the fees had vested prepetition, and they had become part of the lender's allowed claim, but they were subject to section 506(b)'s reasonableness requirement.¹⁹⁴ According to the court, not all the claimed fees were reasonable. The court treated the reasonable portion of the fees as secured, and the unreasonable portion as unsecured. The district court affirmed on the section 506(b) issue, but reversed the bankruptcy court's bifurcation of the fees. The district court denied the lender's claim for any unreasonable fees.¹⁹⁵ A panel of the Eleventh Circuit affirmed,¹⁹⁶ but the decision was withdrawn and reheard *en banc*. The full Eleventh Circuit reversed the district court and reinstated the bankruptcy court's decision.¹⁹⁷

In doing so, the court began with section 506(b) rather section 502. It saw the threshold issue as whether

contractually set fees constitute "reasonable fees" under [section] 506(b), or whether [the secured creditor] automatically has a right

191. GA. CODE ANN. § 13-1-11 (2004). The statute requires the note holder to notify the borrower in writing of the default, and give it 10 days to pay the principal and interest. The attorney's fees only kick in if the borrower fails to pay within that 10 day period. See GA. CODE ANN. O.C.G.A. § 13-1-11(a)(3) (2004).

192. 275 F.3d 1308 (11th Cir. 2001) (*en banc*).

193. *Id.* Its actual expenditure for attorney's fees was approximately \$40,000. *Id.*

194. *Id.* at 1312.

195. *Welzel v. Advocate Realty Investments, LLC (In re Welzel)*, 243 B.R. 916 (S.D. Ga. 1999), *aff'd in part, rev'd in part*, 275 F.3d (11th Cir. 2001) (*en banc*).

196. *Welzel v. Advocate Realty Investments, LLC (In re Welzel)*, 245 F.3d 1283 (11th Cir. 2001).

197. *Welzel*, 275 F.3d 1308.

to the entire fees because they vested pre-petition and were enforceable under state law.¹⁹⁸

In deciding that question, the court relied on section 506(b)'s unambiguous plain meaning.¹⁹⁹

Section 506(b) clearly articulates that the attorney's fees arrangement must be spelled out in the loan contract between debtor and oversecured creditor, but the subsection does not draw a distinction between fees vested pre- or post-petition, as Advocate would have us conclude. Instead, the subsection refers blanketly to "reasonable fees," without differentiation based on the time the fees vested. Nor does the language of [section] 506(b) indicate that just because a given fee arrangement is enforceable under state law, it should be exempt from the reasonableness standard. The literal language refers to whether the loan contract specifies the attorney's fees arrangement, not to whether the arrangement is enforceable under state law.

Furthermore, Congress has shown that when it wants to exempt a particular set of items from the reasonableness standard, it does so explicitly. With regard to interest payments on oversecured claims, section 506(b) conspicuously leaves out the adjective "reasonable," in contrast to the explicit reference to "reasonable fees, costs or charges." This indicates that Congress, by using "reasonable" with respect to one set of items but not another, acted purposefully in deciding whether to include or exclude the reasonableness standard. . . . Had Congress intended to exclude a particular set of contractual attorney's fees from the reasonableness standard—because the fees either had vested pre-petition or were enforceable under state laws . . .—it would have spelled this out. Accordingly, we conclude that in the oversecured creditor context, [section] 506(b) applies a reasonableness standard across-the-board to all contractually set attorney's fees.²⁰⁰

The court had several other arrows in its quiver. The first was a distinction between enforceability and reasonableness. Just because a fee is enforceable at state law does not mean it is reasonable for purposes of section 506(b). In the court's view, section 506(b) "adds a new level of scrutiny to fee arrangements that goes beyond state law requirements."²⁰¹ Moreover, Congress knew how to say state law applied. It did not do so in section 506(b).²⁰² As a bit of an after-

198. *Id.* at 1313-14.

199. This approach differed from that of the vacated panel opinion, which focused on section 506(b)'s legislative history rather than its plain language. *Welzel*, 245 F.3d at 1285-86 (collecting cases).

200. *Welzel*, 275 F.3d at 1314-15.

201. *Id.* at 1315.

202. *Id.*

thought, the court turned to legislative history²⁰³ as the final triumphal justification that section 506(b)'s reasonableness standard trumped state law.

Having disposed of the section 506(b) issue, the court considered how to treat the unreasonable portion of the attorney's fees. Relying on the "language and structure" of sections 502 and 506(b), it concluded bifurcation was the proper approach, and no equitable considerations prevented its application.

The court first analyzed allowance and disallowance of claims under the Code. Once a creditor files a proof of claim under section 501, its claim is allowed unless a party in interest objects.²⁰⁴ Even if objection is made, the bankruptcy court must allow the claim as filed unless a specific exception says otherwise.²⁰⁵ In this case, no section 502(b) subsection applied to the unreasonable portion of the attorney's fees. The court once again stressed the distinction between reasonableness and enforceability. An unreasonable claim for attorney's fees could not be an allowed secured claim under section 506(b), but it *could* be an allowed *unsecured* claim under section 502(b).

The court's bottom line was that the two sections

should be read in tandem with one another, for they address complementary but different questions. Section 502 deals with the threshold question of whether a claim should be allowed or disallowed. Once the bankruptcy court determines that a claim is allowable, [section] 506 deals with the entirely different, more narrow question of whether certain types of claims should be considered secured or unsecured.²⁰⁶

How should a bankruptcy court apply this in practice?

The threshold question is whether Advocate's claim for its contractually set attorney's fees is allowed under [section] 502. The entire claim to fees is allowable under [section] 502 as long as the exceptions in subsection (b) do not apply. As already noted, none of these exceptions apply here, so Advocate's claim for its contractual attorney's fees passes muster under [section] 502. Given that the fees claim is allowed, the fees must then be assessed for reasonableness under [section] 506(b). Reasonable fees are then to be treated as a secured claim. If a portion of the fees are deemed unreasonable, however, the fees should be bifurcated between the reasonable portion, treated as a secured claim, and the unreasonable portion, treated as an unsecured claim. By failing to adopt this bifurcation

203. The court did not delve deeply into section 506(b)'s legislative history. Instead it relied on two cases which had undertaken "an exhaustive review" of that legislative history: *268 Ltd.*, 789 F.2d at 676-77; *K.H. Stephenson Supply*, 768 F.2d at 582-85.

204. 11 U.S.C. § 502(a) (2000).

205. 11 U.S.C. § 502(b) (2000).

206. *Welzel*, 275 F.3d at 1317-18.

approach and instead disallowing unreasonable fees, the district court erred.²⁰⁷

The court turned to the debtor's argument that allowing the lender an unsecured claim for unreasonable attorney's fees constituted a windfall that the court should disallow under its equitable powers. Given its reliance on the language and structure of sections 502(b) and 506(b), the court rejected this argument.²⁰⁸

Finally the court noted that a decision not to bifurcate the creditor's claim would prefer unsecured creditors over secured creditors. Section 506(b) does not apply to unsecured creditors. Unsecured creditors with comparable claims would hold an allowed claim for the entire contractual amount. Secured creditors would forfeit a substantial part of their claims. This was an "absurd result."²⁰⁹

VI. CONTRACTS THAT PROHIBIT PREPAYMENT BUT DO NOT PROVIDE A PREPAYMENT PENALTY

*In re Vest Assocs.*²¹⁰ provides another interesting twist. The loan agreement prohibited the debtor from prepaying the loan (a "lock out" or "lock in" provision) but it did not provide a remedy in the event of prepayment. The debtor filed bankruptcy. After attempts to refinance proved futile, the debtor sold the property to fund a liquidating plan. The lenders filed a claim for \$200,000 representing losses resulting from the debtor's prepayment and \$92,000 in income tax liability incurred as a result of a sale of the property and prepayment.²¹¹

The lenders ultimately conceded their failure to include a damage or penalty provision in the loan documents precluded them from recovering damages "or any lost interest opportunity or other damages resulting from prepayment."²¹² They sought compensation for the adverse tax consequences they had suffered. They based their request on section 105. The court characterized their request as in conflict with section 506(b) which authorizes fees, costs or charges *so long as they are provided for under the loan documents.*²¹³

Other than an appeal to my equitable powers, the [lenders] do not supply any legal authority for the proposition that a bankruptcy court may read into a contract damage provisions which the parties themselves have failed to insert regarding the liquidation or calcula-

207. *Id.* at 1318.

208. *Id.*

209. *Id.*

210. 217 B.R. 696 (Bankr. S.D.N.Y. 1998).

211. *Id.* at 699.

212. *Id.*

213. *Id.*

tion of damages arising out of the prepayment of a loan or note. Unremarkably, there is no supportive decisional law. On the other hand, as one bankruptcy judge recently noted, there is no reported decision which allows a prepayment premium in the absence of a formula for the calculation of that premium being set forth in the instrument.²¹⁴

Does the court's reasoning make sense? If a contract prohibits a debtor from prepaying and the debtor prepays, the debtor has breached the contract. At common law, the creditor, as an aggrieved party, is entitled to damages for that breach, just like any other party aggrieved by the other party's breach. According to traditional contract rules, an aggrieved party is entitled to all damages proximately caused by the breach if the damages were reasonably foreseeable at the time of contracting, they were unavoidable, and the aggrieved party can prove them with a reasonable degree of certainty.

Was the court justified in refusing to supply a remedy when the creditors failed to do so in their contract? Why could the court not fill in the gap following traditional common law contract principles? Although Judge Brozman does not address the question, one assumes she was unwilling to supply a remedy because the issue arose under section 506(b) and section 506(b) only recognizes charges, fees and costs *provided by the agreement*. Section 506(b) is federal law. Federal law does not recognize a charge, fee or cost that is not provided by the contract. Therefore, the court was powerless to supply a remedy.

Exactly what a court can and cannot do under section 506(b) is not clear. Some courts have supplied a different remedy from the remedy provided by the parties' agreement. When a court concludes a YMP is unenforceable because damages are easy to estimate,²¹⁵ or enforcement will overcompensate the lender,²¹⁶ it might go on to hold the lender is entitled to its actual damages from early loan termination.²¹⁷ One court wrote:

We recognize that prepayment premiums are intended to protect lenders from a drop in interest rates between the date a loan is made and the prepayment date . . . and a lender may have a contractual right to collect the full amount of a prepayment premium under nonbankruptcy law. . . . In our view, however, a lender is entitled, under section 506(b), to collect only the difference between (1) the

214. *Id.*

215. *A.J. Lane*, 113 B.R. 821.

216. *See, e.g., In re Schwegmann Giant Super Markets*, 287 B.R. 649 (E.D. La. 2002); *but see Hidden Lake*, 247 B.R. 722 (YMP enforced even though it would overcompensate secured creditor).

217. *Morse Tool*, 87 B.R. at 751.

market rate of interest on the prepayment date, and (2) the contract rate, for the remaining term of the loan.²¹⁸

Because the bankruptcy court had recognized the lender's full YMP, the BAP remanded to the bankruptcy court to take evidence on the market rate of interest at the time of prepayment and to "allow the secured claim accordingly."²¹⁹

When a court orders a different remedy from the remedy posited in the parties' contract, the court is supplying a remedy the parties' agreement did not provide. Technically, section 506(b) does not seem to authorize that.

VII. SECTION 1124 NONIMPAIRMENT & YMPs

*Continental Securities Corp. v. Shenandoah Nursing Home Partnership*²²⁰ is another case involving a loan agreement that prohibited prepayment but failed to provide a remedy in the event of breach. The issue in *Continental* arose in the context of a chapter 11 plan. The debtor's plan proposed to "cash out" the lender, that is, pay the lender's claim plus accrued interest. The proposed cash out did not include any compensation for the debtor's breach of the prepayment prohibition even though the cash out represented prepayment in violation of the parties' agreement.

The lender argued the plan impaired its claim. The plan "re-wrote the terms of the Note, stripping [the lender], without compensation, of the lost income stream generated by the Note as originally drafted."²²¹ The plan altered its contractual and legal rights. Moreover, the lender asserted, it was not getting under the plan what it would get in a hypothetical liquidation. Therefore, the "best interests" test was not met and the court could not confirm the plan.

The court agreed the proposed plan did indeed alter its contractual rights. However, section 1124(3) of the Bankruptcy Code established that it was unimpaired by the plan.²²² Section 1124(3) defined "cash out" as nonimpairment.

The lender's impairment argument presupposed its claim included a prepayment penalty. But the contract did not provide a penalty for prepayment. It only prohibited prepayment. Because the contract

218. *Imperial Coronado Partners*, 96 B.R. at 1001.

219. *Id.*

220. 193 B.R. 769 (W.D. Va. 1996).

221. *Id.* at 774.

222. Until 1994, section 1124 had subsection (3) which essentially provided that a claim was unimpaired if it was cashed out on the effective date of the plan. The 1994 amendments to the Bankruptcy Code deleted section 1124(3).

did not provide a prepayment penalty, section 506(b) did not recognize it. Therefore, the lender's claim in bankruptcy was limited to unpaid principal and accrued interest. The plan's proposal to pay principal and accrued interest on the effective date of the plan meant the lender's claim was unimpaired. Because the plan did not impair the claim, section 1129(a)(7) did not apply because it only applies to *impaired* classes of claims. The fact of nonimpairment meant it was irrelevant that the lender would receive more in a hypothetical liquidation.

Along with underscoring the need to provide a remedy for breach of a lock in provision, *Continental Securities* teaches that a chapter 11 debtor can avoid a YMP by unimpairing the YMP holder. (Nonimpairment today also means the best interests test does not apply.) But nonimpairment also means the lender under the plan gets exactly what it bargained for, including the interest rate for the duration of the bargained-for loan term. Nonimpairment is a wonderful strategy to stifle a lender if the debtor wants to continue the existing loan. It is not a meaningful strategy if the debtor does not want to or cannot continue under the existing loan terms.

VIII. YMPs AND "THE EQUITIES OF THE CASE"

*In re Schwegmann Giant Supermarkets Partnership*²²³ involved a \$1,295,254.44 YMP.²²⁴ The property was sold postpetition, netting in excess of \$15 million. The creditor was paid its principal of \$7 million. The debtor escrowed over \$1.4 million for the account of the creditor.

The court concluded the YMP was not a reasonable charge under section 506(b). The YMP was the greater of (1) a fixed ten percent of the prepaid principal; or (2) "the sum of a figure based on the difference in value of payments under current versus contract interest rates plus 1% of prepaid principal."²²⁵ The lender had failed to introduce any evidence as to any actual damages from prepayment. In fact, the lender's representative testified that "he had 'no idea' what [the lender's] damages would be as a result of the payment of the loan ahead of schedule."²²⁶ In addition, the court noted that the debtor was not in default under the note when it filed bankruptcy and it stayed current on its note throughout the course of the bankruptcy.²²⁷ And most importantly, some lower ranked secured lenders would re-

223. 264 B.R. 823 (Bankr. E.D. La. 2001).

224. *Id.* at 825.

225. *Id.* at 828.

226. *Id.* at 830.

227. *Id.*

ceive nothing if the creditor were awarded the YMP,²²⁸ not to mention the unsecured creditors.²²⁹

According to the court, it had to “consider the equities in making the determination as to whether the prepayment premium is reasonable.”²³⁰ After reciting that the debtor was not in default and did not want to sell the property, etc., etc., the court cut to the chase:

If [the lender’s YMP] is paid in full, the junior secured creditors and unsecured creditors of the debtor will not be paid in their entirety. The net effect of allowing [the lender] the premium it seeks is not to redress [the lender] for its damages, but instead to penalize the debtor and junior creditors for the debtor’s filing of [c]hapter 11 relief — a highly inequitable result that this court is not willing to condone under all the circumstances of the case.²³¹

And, so, the court disallowed the lender’s YMP.

Apparently, lenders are not preparing very well for trial. In another case,²³² another lender’s representative testified that “he had no idea whether [the lender] could obtain a higher rate of return than the rate of interest on the promissory note in question.”²³³ That failure meant the lender had failed to prove its actual damages from prepayment. But

[e]ven if [the lender] could prove its actual damages from the prepayment, the Court must still determine that the equities favor allowing [the lender] to recover its penalty. . . . Here, because the Contractors’ mechanics liens are junior to [the creditor’s] deed of trust, allowing [the lender] to collect its prepayment penalty would substantially harm the Contractors. Also, [the lender] will collect approximately \$50,000 in default interest. Further [it] will collect its attorneys’ fees expended in litigating this action. Under such circumstances, the Court finds that it would be inequitable to allow [the creditor] to collect the prepayment penalty.²³⁴

In a word, lenders seeking to recover a YMP need to be able to prove their actual damages and even then, their ability to collect the YMP is not certain.

228. *Schwegmann Giant Supermarkets P’ship*, 264 B.R. at 830.

229. *Id.* at 832.

230. *Id.* at 831.

231. *Id.* at 832.

232. *Sachs Elec. Co. v. Bridge Info. Sys. (In re Bridge Info. Sys.)*, 288 B.R. 556 (Bankr. E.D. Mo. 2002).

233. *Id.* at 564.

234. *Id.*

IX. SOLVENT DEBTORS AND YMPs

In *In re Vanderveer Estates Holdings, Inc.*,²³⁵ the court held the creditor was entitled to its YMP. The YMP in *Vanderveer* was carefully crafted in response to the YMP case law. Moreover, and we think most significantly, the debtor in *Vanderveer* was solvent.

In *Vanderveer*, the debtor owed the mortgagee in excess of \$75 million. The terms of the note entitled the mortgagee to payment of a YMP

in connection with *any* prepayment of the loan, “*whether the prepayment is voluntary or involuntary (in connection with holder hereof’s acceleration of the unpaid principal balance of this Note) or the Instrument is satisfied by foreclosure (whether by power of sale or judicial proceeding), deed in lieu of foreclosure or by any other means.*”²³⁶

The debtor defaulted prepetition. The mortgagee accelerated prepetition. At the time of acceleration, the mortgagee demanded payment of the YMP. The debtor petitioned for chapter 11 relief. “It was agreed that the debtor was not insolvent” at the time of confirmation.²³⁷

The debtor’s plan treated the mortgagee’s claim as fully secured but the claim did not include the YMP. The plan proposed to pay the mortgagee’s claim over the remaining term of the note at the note’s non-default rate of interest. So, the plan was *not* proposing to prepay the mortgage. The mortgagee’s claim was impaired under the plan even though the plan proposed to maintain the note’s original term and interest rate. The plan modified the mortgagee’s rights in other ways including capitalization of millions of dollars in interest arrears.²³⁸ The plan proposed to pay all the unsecured creditors in full with interest on the effective date of the plan.

In addition to objecting to confirmation, the mortgagee filed a motion for determination of secured status. It maintained its secured claim included, among other things, the YMP.

The court’s YMP analysis began with addressing whether the mortgagee had a right to receive the YMP given that the debtor’s plan did not propose prepayment. The debtor argued the YMP was only due upon prepayment and the plan was not proposing to prepay. Therefore, it was not triggered. The creditor argued the YMP accrued upon

235. 283 B.R. 122 (Bankr. E.D.N.Y. 2002).

236. *Id.* at 126 (emphasis added).

237. *Id.*

238. *Id.* at 126.

acceleration.²³⁹ The court said it did not have to decide the issue because the plan impaired the mortgagee's rights and therefore, the plan's treatment of the mortgagee's claim had to satisfy section 1129(a)(7). Even if the debtor were right, and the YMP did not accrue until prepayment, the YMP would be triggered in a chapter 7 because liquidation *would result* in prepayment. Therefore, the YMP was part of the mortgagee's claim and the plan had to pay it to satisfy the best interests of creditors test *if* the YMP was enforceable under state law *and* allowable under section 506(b).²⁴⁰

The court looked first to New York law, relying heavily on two Second Circuit cases.²⁴¹ According to the terms of the note, the YMP was calculated by

subtracting the yield on a Treasury Note of comparable maturity from the note interest rate, applying the difference to the remaining principal balance at the time of prepayment, and discounting that amount to present value.²⁴²

The court concluded the YMP was a valid liquidated damages clause under New York law. Actual damages were difficult to estimate and the sum stipulated was not "plainly disproportionate" to the possible loss.²⁴³ Actual damages were difficult to quantify because several speculative variables existed including "the loss of interest to the lender, the rate of return on any substitute loan . . . , the duration of that loan . . . and the extent and realizability of the collateral for the substitute loan" ²⁴⁴ Moreover, the YMP reflected the parties' genuine attempt to forecast damages. The YMP formula did not produce an automatic premium to the lender in the event of prepayment. If interest rates went up after the loan was made, the formula would produce a zero premium.²⁴⁵ In its discussion, the court also mentioned that the YMP "was the product of arm's-length negotiations between sophisticated parties represented by counsel."²⁴⁶

Having concluded the YMP was enforceable at state law, the court turned to the YMP's status in bankruptcy. The court noted that if the mortgagee's right to the YMP had accrued upon acceleration, it would

239. *Id.* at 126-27.

240. *Vanderveer Estates Holdings*, 283 B.R. at 127.

241. *United Merchs. and Mfrs.*, 674 F.2d 134; *Walter E. Heller & Co. v. American Flyers Airline Corp.*, 459 F.2d 896 (2d Cir. 1972); *Vanderveer Estates Holdings*, 283 B.R. at 128-29.

242. *Vanderveer Estates Holdings*, 283 B.R. at 132.

243. *Id.* at 129.

244. *Id.* at 130.

245. *Id.*

246. *Id.*

be part of the mortgagee's *prepetition* claim.²⁴⁷ The debtor could not point to any Bankruptcy Code provision that would limit, restrict, or disqualify the YMP as part of the mortgagee's *prepetition* claim. But, even if the YMP had to pass muster under section 506(b), it would.

The debtor relied on YMP case law to argue that charges are inherently unreasonable under section 506(b) unless they effectively measure a lender's *actual* damages.²⁴⁸ The court rejected the argument and distinguished the cases. The YMP formula in *Vanderveer* did not presume a loss. Moreover, it discounted the damages to present value.²⁴⁹

Indeed, the court observed, the debtor's only quarrel with the YMP formula was that it measured lost interest using the current yield on a Treasury Bill of comparable maturity rather than the current market rate for mortgages.

This objection presumes that the lender will be able immediately to invest the prepaid monies in a loan of comparable risk, size and maturity. However, the parties, in negotiating the loan agreement, chose not to make this assumption. . . . This choice of a Treasury Bill benchmark is not inherently unreasonable.²⁵⁰

According to the court, a YMP might impose such a large charge and be so unfair to the estate and its creditors that it would be struck down as unreasonable under section 506(b), but this was not such a case.²⁵¹

If the debtor is solvent, *In re 360 Inns, Ltd.*²⁵² identifies yet another way for a lender to receive its YMP. If the YMP is not enforceable as a reasonable liquidated damages clause, — if it is not a reasonable charge under section 506(b), — presumably it *is* a penalty and as a penalty, section 726(a)(4) requires the trustee to pay it in full to the creditor before the trustee pays anything to the debtor. So, in a hypothetical liquidation (of a solvent debtor), the creditor would receive the YMP. Consequently, confirmation under section 1129(a)(7) would require the debtor's plan to provide for it.²⁵³

X. WHERE ARE WE NOW AND WHAT YMP CHALLENGES LIE AHEAD?

Would the court in *Vanderveer* have reached the same result had the debtor been insolvent? One can only wonder, but the opinion identi-

247. *Vanderveer Estates Holdings*, 283 B.R. at 131.

248. *Id.* at 132.

249. *Id.*

250. *Id.*

251. *Id.* at 133.

252. 76 B.R. 573 (Bankr. N.D. Tex. 1987).

253. *Id.* at 576.

fies two continuing sources of potential vulnerability - two possible soft spots - for even the most carefully crafted YMP: (1) its enforceability at state law, and (2) its reasonableness under section 506(b). Even if the YMP is state-of-the-art in terms of draftsmanship and the YMP is due and payable whether the lender has or has not accelerated and whether prepayment is or is not voluntary, wiggle room remains. Section 506(b)'s concept of reasonableness and the state law "rules" regarding stipulated damage clauses are both sufficiently malleable to justify any conclusion a court wants to reach.

Moreover, most debtors in bankruptcy are insolvent. That means the rights of others will be part of the court's calculus, either explicitly or sub-rosa. If enforcement of the YMP will overcompensate the YMP holder to the detriment of the debtor's other creditors, we think many courts will find a way to deny effect to the YMP.

Stay tuned.