PREPAYMENT CLAUSES IN BANKRUPTCY

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INTRODUCTION

Provisions governing the repayment of debt prior to its scheduled maturity are a fixture of commercial loan agreements. Some of these provisions—referred to as "no calls"—simply prohibit such prepayment. Other provisions permit prepayment, but require the borrower to pay a "prepayment fee." Prepayment fees themselves

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take various forms: While some are based on "yield maintenance" formulas that estimate the damages to lenders resulting from prepayment, others are fixed at a percent of the amount being prepaid.[1]

The purpose of prepayment clauses is to determine the parties' respective rights in the event that prepayment becomes economically efficient for a borrower. Absent any limitation on prepayment, a rational borrower will repay its debt as soon as the benefits of refinancing exceed the transaction costs of procuring a new loan. Such a borrower, therefore, will generally repay a fixed-rate loan when market interest rates decline, and will repay any loan (fixed or floating rate) when its creditworthiness improves relative to the market. Prepayment clauses change the borrower's incentives. Faced with a flat prohibition on prepayment, a rational borrower will repay its debt prior to maturity only if the economic benefits of prepayment—either in the form of lower borrowing costs or improved contract terms—exceed the damages resulting from breach of the loan agreement. Similarly, when faced with a prepayment fee, the borrower will repay its debt only when the benefits from prepayment are greater than the fee. Prepayment clauses, in sum, allow a lender to negotiate for yield protection and a borrower to negotiate for freedom of action.[2]

This article explores the ramifications of a borrower's bankruptcy filing on the enforcement and application of prepayment clauses. The Bankruptcy Code, in section 502(b)(2),[3] disallows claims for unmatured interest, the expectancy of which is precisely what prepayment clauses, at least insofar as they approximate damages resulting from prepayment, are intended to protect. At the same time, section 506(b) provides that to the extent a secured creditor's collateral has a higher value than its claim, the creditor has a valid secured claim both for post-petition interest and for "any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose."[4] Notwithstanding section 502(b)(2), therefore, section 506(b) protects an oversecured creditor's entitlement to be compensated for prepayment if such compensation is properly described either as "interest" or as a reasonable "fee," "cost," or "charge" provided for in the loan agreement.

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[1] *See* River East Plaza, LLC v. Variable Annuity Life Ins. Co., No. 06-3856, 2007 WL 2377383, at *3 (7th Cir. Aug. 22, 2007) (distinguishing no calls from prepayment fees and fixed prepayment fees from yield maintenance formulas); Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 869–71 (1993) (offering a detailed "taxonomy of prepayment fee clauses").

[2] *See generally* Whitman, *supra* note 1, at 871–81 (describing prepayment fees as a "a form of insurance" for lenders and analyzing the economic goals achieved by prepayment clauses); *In re* MarketXT Holdings Corp., No. 04-12078, 2007 WL 2967233, at *18 (Bankr. S.D.N.Y. Oct. 12, 2007) (describing prepayment clause as "a liquidated damages clause designed to compensate a lender for costs incurred in connection with early payment of a long-term loan, resulting from the possibility that interest rates will be lower when the repaid funds are relent, or that the lender will not be able to rely on a stable flow of funds over a known period").

[3] 11 U.S.C. § 502(b)(2) (2006). Citations to the "Bankruptcy Code" refer to title 11 of the United States Code.

[4] 11 U.S.C. § 506(b).

These statutory provisions raise as many questions as they answer. Section 506(b) offers no guidance as to how to assess the "reasonableness" of a contractual prepayment fee. Likewise, section 502(b)(2) is silent as to whether prepayment fees, or damages for breach of a no call, are properly viewed as unmatured interest. The Bankruptcy Code also does not address a threshold question that has proven significant in recent cases: Does the automatic acceleration of a debt's maturity as a result of a bankruptcy filing mean that the repayment of debt in bankruptcy is not a "voluntary prepayment," such that a typical prepayment clause does not apply?

To lay the groundwork for the article, Part I divides prepayment clauses into several categories. Part II then analyzes the effect of automatic acceleration (by law or contract) on prepayment clauses. This issue is discussed early in the analysis because, to the extent that acceleration is deemed to render a particular prepayment clause inapplicable, there is no need to determine whether the clause is enforceable under section 506(b) or 502(b) of the Bankruptcy Code.

Part III deals with the application of section 506(b) to prepayment clauses. First, it summarizes the case law applying section 506(b) to prepayment fees and shows that, because such fees are generally treated as liquidated damages clauses and as "charges," they have been enforced in bankruptcy if they pass muster under state liquidated damages law and are "reasonable" under section 506(b). No call provisions, in contrast, generally have *not* been enforced under section 506(b), because the damages that arise from their breach are not "provided for" in a loan agreement. Part III goes on to analyze the cases applying section 506(b) to prepayment clauses, and concludes that they have not recognized a meaningful distinction between, on the one hand, (a) clauses that effectively grant a borrower an option to prepay in exchange for a fixed fee and, on the other hand, (b) liquidated damages clauses, *i.e.*, provisions that actually attempt to approximate damages. Part III concludes that the amounts fixed by true liquidated damages clauses, along with the damages arising from breach of a no call, are most reasonably treated as "interest" for purposes of section 506(b), because those amounts are intended to approximate the lender's expected yield absent prepayment. Fixed prepayment fees, on the other hand, can reasonably be treated as "charges," since they bear no necessary relation to the lenders' lost yield. Section 506(b), in sum, should be interpreted to protect claims that arise from yield maintenance formulas, no calls, *and* fixed prepayment fees, albeit for different reasons.

Part IV considers whether unsecured and undersecured creditors can assert valid claims based on prepayment clauses, notwithstanding (i) section 506(b)'s exclusive protection of oversecured creditors, and (ii) section 502(b)(2)'s general disallowance of claims for unmatured interest. Part IV shows that, although some courts have interpreted section 506(b) as an implicit bar on *un*secured claims for contractual "fees" or "charges," most courts have ignored section 506(b) in evaluating unsecured claims for prepayment fees, and have rejected the notion that such fees are tantamount to unmatured interest. Part IV concludes that section 506(b) probably should not be interpreted to bar the allowance of unsecured claims;

however, section 502(b)(2) arguably should be interpreted to preclude claims based on no calls or true liquidated damages clauses, which are fundamentally claims for lost yield. Finally, Part V discusses the status of prepayment clauses in *solvent* cases, and concludes that, in such cases, bankruptcy courts do not have equitable discretion to disallow claims that would be valid under state law.

The issues discussed in this article have attracted significant attention in recent bankruptcy cases, including *Northwest Airlines* and *Calpine*. In those cases, chapter 11 debtors have taken advantage of favorable borrowing conditions to repay billions of dollars of secured debt outside of a plan of reorganization. The issues discussed below, however, are as likely to emerge within the plan context as outside it. Under section 1129(a)(7)(A)(ii) of the Bankruptcy Code, commonly described as the "best interests" test, a court cannot confirm a chapter 11 plan unless the plan gives dissenting members of an impaired class of claims at least what they would receive "if the debtor were liquidated under chapter 7 [of the Bankruptcy Code]" on the effective date of the plan.[5] A prepayment fee, if enforceable in bankruptcy against a debtor, would be payable to secured lenders if the debtor were liquidated. Consequently, if a debtor proposes to repay the principal amount of a lender's debt, its plan can be confirmed under the "best interests" test only if the lender's rights under a prepayment clause are enforced.[6] Furthermore, under section 1129(b)(2)(A)(ii) of the Bankruptcy Code, when a class of creditors objects to a plan, the plan cannot be confirmed unless it is "fair and equitable"—*i.e.*, consistent with the Code's "absolute priority rule." Thus, if the proponents of a plan propose to deprive senior creditors of an *enforceable* prepayment fee, but also distribute value to junior creditors, that plan too will not be confirmable.[7] Both inside and outside of the plan context, therefore, the validity and application of prepayment clauses will continue to be the source of bankruptcy litigation, especially in low interest rate environments.

I. VARIETIES OF PREPAYMENT CLAUSES

The ubiquity of prepayment clauses, as well as the case law questioning their enforceability by lenders, makes it easy to forget that they are not necessary under state law to protect a lender's yield. Under the "perfect tender in time" rule, a commercial borrower "has no right to pay off his obligation prior to its stated

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[5] 11 U.S.C. § 1129(a)(7)(A)(ii) (2006); *see, e.g.*, Granada Wines, Inc. v. New England Teamsters and Trucking Indus. Pension Fund, 748 F.2d 42, 44 (1st Cir. 1984) ("Under . . . section [1129(a)(7)(A) of the Bankruptcy Code], either all creditors must accept the plan, or each creditor must receive under the plan at least as much as it would receive under a Chapter 7 liquidation.").

[6] For a detailed discussion of the interrelationship between prepayment fees and section 1129(a)(7)(A)(ii), see Ingrid Michelsen Hillinger, *The Story of YMPs ("Yield Maintenance Premiums") in Bankruptcy*, 3 DEPAUL BUS. & COM. L.J. 449, 452–55 (2005).

[7] Similarly, if the proponents of a plan propose to pay senior creditors an *unenforceable* prepayment fee, junior stakeholders may object to confirmation on the basis that the plan distributes value to senior creditors that belongs to them. *Cf. In re* Granite Broad. Corp, 369 B.R. 120 (Bankr. S.D.N.Y. 2007) (resolving objection by preferred equityholders to plan that, in their view, overcompensated senior creditors).

maturity date in the absence of a prepayment clause."[8] That common law rule was adopted by an American state court as early as 1829,[9] and was universally accepted a century later.[10] Although the rule is no longer inviolate (it has been rejected in several states[11] and roundly criticized by scholars[12]), it remains the law of New York and many other jurisdictions.[13]

The default rule that a loan may not be prepaid invites a separate question: whether lenders can refuse prepayment or, alternatively, have to sue for damages in the event they are prepaid. This question too has divided state courts. Some cases, including the earliest cases to embrace the perfect tender in time rule, either assume or hold that prepayment absent consent is not just a breach but, rather, an impossibility.[14] Other cases effectively treat prepayment as a breach that can be remedied by paying the lender whatever interest would be payable through the original maturity of the loan.[15]

A. No Calls

Against this common law backdrop, it is apparent that a contractual prohibition on prepayment—*i.e.*, a "no call"—does no more than memorialize the rule of

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[8] Arthur v. Burkich, 520 N.Y.S.2d 638, 639 (N.Y. App. Div. 1987).

[9] Abbe v. Goodwin, 7 Conn. 377 (1829), has been identified as the first American case to embrace the perfect tender in time rule. *See, e.g.*, Rebecca C. Dietz, *Silence is Not Always Golden: Mortgage Prepayment in the Commercial Loan Context*, 22 UNIV. OF BALT. L. REV. 297, 307 (1993).

[10] For a thorough history of the perfect tender in time rule, see Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 CORNELL L. REV. 288, 308–09 (1987).

[11] *E.g.*, Hatcher v. Rose, 407 S.E.2d 172, 177 (N.C. 1991) (departing from *Burkich*; North Carolina statutes recognize prepayment right); Mahoney v. Furches, 468 A.2d 458 (Pa. 1983) (holding that default rule restricting prepayment would be unlawful restraint on alienation); Skyles v. Burge, 789 S.W.2d 116, 119 (Mo. Ct. App. 1990) (indicating that Missouri statutes reject perfect tender in time rule). The minority approach, under which prepayment by a borrower is presumed to be permissible, has sometimes been called the "civil law rule." *See* George A. Nation, III, *Prepayment Fees In Commercial Promissory Notes: Applicability to Payments Made Because of Acceleration*, 72 TENN. L. REV. 613, 619 n.27 (2005).

[12] For example, Frank S. Alexander argues that the rule lacks any foundation in English common law, Alexander, *supra* note 10, at 298–308, and that the economic justifications for the rule, including the need for predictable returns on investment, have been used to grant lenders more than the benefit of their bargain (for example, in cases in which interest rates have risen). *Id.* at 310–18. Dale A. Whitman agrees with Alexander that "[w]ithout doubt the standard rule ought to be reversed," because a lender can easily restrict or limit prepayment to the extent desirable. Whitman, *supra* note 1, at 858–59.

[13] *See, e.g.*, Friends Realty Assocs., LLC v. Wells Fargo Bank, N.A.P., 836 N.Y.S.2d 565, 565 (N.Y. App. Div. 2007); Nw. Mutual Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006) (citing *Arthur v. Burkich* with approval); *see also, e.g.*, LaSalle Bank v. Mobile Hotel Properties, LLC, 367 F. Supp. 2d 1022 (E.D. La. 2004) (Alabama); Martino v. Schloss, 2005 Conn. Super. LEXIS 1467, at *7 (June 1, 2005) (Connecticut); Trilon v. Controller of the State of New York, 788 A.2d 146, 151–53 (D.C. 2001) (District of Columbia); DiMarco v. Shay, 796 N.E.2d 572, 575–76 (Ohio Ct. App. 2003).

[14] *See* Alexander, *supra* note 10, at 313 & n.136 (citing cases, including *Abbe v. Goodwin*, holding creditors are not obliged to accept prepayment even if accompanied by interest owing through original date).

[15] *See id.* at 313 & nn.134, 135 (citing cases in which courts have allowed prepayment along with payment of unaccrued interest). Alexander notes that, by requiring borrowers to pay *all* interest that would accrue through a scheduled maturity date, some courts have granted creditors far more than their anticipated yield, which could be protected at least in part through reinvestment. *Id.* at 313 & n.133.

perfect tender in time. Like that default rule, a no call makes prepayment into a breach, but it does not liquidate the damages attendant to such a breach.

In a widely cited series of decisions, federal courts in the Southern District of New York have explained that damages for breach of a no call are equal to the present value of "the difference between (a) the interest income [the lender] would have earned had the contract been performed, and (b) the interest income [the lender] would be deemed to have earned by timely mitigating its damages—*i.e.*, by making an investment with similar characteristics at the time of the breach."[16] If this damages model is properly applied, such that a borrower making a prepayment has to put lenders in the same position as if the loan were repaid on its original schedule, a lender should not be materially harmed by prepayment. In connection with a floating-rate loan, since the borrower will already capture the benefit of declining interest rates under the terms of its loan agreement, the borrower has no reason to breach a no call simply because interest rates decline. And if the borrower's creditworthiness improves, such that it can either obtain lower interest rates (beyond any market decline) or better non-economic loan terms, the borrower is obligated to compensate the lender for lost yield—*i.e.*, the difference between the parties' bargained-for interest and the interest available to lenders in the market for a loan with similar terms.

In a fixed-rate scenario, lenders are likewise protected by a no call. If the borrower seeks to refinance as a result of a decline in market interest rates, the amounts saved by refinancing will closely correlate to the lenders' damages; thus, the borrower does not benefit from refinancing solely because interest rates have declined.[17] As with floating-rate loans, the borrower may benefit from refinancing if its creditworthiness improves for unique reasons, because in that situation the interest-rate savings *or* non-economic benefits (such as looser covenants) resulting from refinancing will surpass the damages owed to lenders. In all circumstances, however, lenders are protected by a no call—assuming (and these are major

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[16] Teachers Ins. & Annuity Ass'n of Am. v. Coaxial Communs. of Cent. Ohio, 799 F. Supp. 16, 19 (S.D.N.Y. 1992); Teachers Ins. & Annuity Assoc. v. Ormesa Geothermal, 791 F. Supp. 401, 415–17 (S.D.N.Y. 1991); *accord* Teachers Ins. & Annuity Ass'n. v. Butler, 626 F. Supp. 1229, 1236 (S.D.N.Y. 1986) (using same measure of damages where liquidated damages clause in loan commitment letter provided, in event of breach by borrower, lenders would be awarded "all provable damages, including loss of bargain, sustained by [them] as a result of such default"). Bankruptcy courts seeking to quantify the actual damages to lenders resulting from prepayment have used the same formula as the *Teachers* courts. *E.g.*, *In re* Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("[A]ctual damages are measured by the difference between: 1) the market rate of interest on the prepayment date, and 2) the contract rate, for the remaining term of the loan, then discounted to arrive at present value."); *accord In re* Imperial Coronado Partners, Ltd., 96 B.R. 997, 1001 (B.A.P. 9th Cir. 1989); *In re* Duralite Truck Body & Container Corp., 153 B.R. 708, 714 (Bankr. D. Md. 1993); *In re* A.J. Lane & Co., 113 B.R. 821, 829 (Bankr. D. Mass. 1990).

[17] Whitman, *supra* note 1, at 865 ("[I]n most cases the borrower will experience *no* direct economic advantage from prepayment under a legal rule that requires payment of full damages. In general, the borrower may refinance at a lower rate of interest and save considerable money over time, but the damages that must be paid to the old lender as the price of the prepayment will precisely equal the present value of those savings.").

assumptions) that damages for breach are accurately calculated and fully compensatory.

Where parties agree to a no call, therefore, the borrower is likely to prepay its debt only if, for idiosyncratic reasons, the lenders' damages from prepayment will be lower than the borrower's savings from refinancing (or their economic equivalent in the form of improved contract terms). In those circumstances, the borrower will either breach its contract and pay the resulting damages or, in order to avoid litigation, pay the lenders a share of the savings/damages spread in exchange for a waiver of the no call.

B. Prepayment Fees

While a no call memorializes the common law default rule that prepayment is not permitted absent lender consent, a prepayment fee effectively opts out of that default rule, as it *permits* prepayment as long as a fee is paid. Prepayment fees take two primary forms: fixed fees and so-called yield maintenance formulas.

1. Fixed Prepayment Fees

A fixed prepayment fee permits a borrower to repay its debt prior to maturity in exchange for a fixed sum. The fee can be calculated in several ways. It can require payment of a specific dollar amount or, more typically, a percentage of the outstanding principal loan balance. If prepayment is allowed upon payment of a percentage of the loan balance, that percent can either (i) stay the same throughout the term of the loan or (ii) decline or disappear as the loan gets closer to maturity. A fixed prepayment fee can also be combined with a no call: for example, a loan with a fifteen-year term can be non-callable for its first ten years and then callable at 2% of the prepaid amount for the remainder of the loan's term.

A fixed prepayment fee is beneficial to borrowers because, unlike a no call or a formula that seeks to approximate actual damages in some manner, a reasonable fixed fee has an upper limit. Thus, once a borrower's projected savings from prepayment exceed the fixed fee, the borrower alone captures all those savings (minus transaction costs). The downside of a fixed prepayment fee for borrowers is that, if the lenders' actual damages from prepayment are *below* the fixed fee, payment in full of those damages will not suffice to allow prepayment. As a result, even if the borrower's expected savings from refinancing are greater than the lenders' lost yield—*e.g.*, because the borrower's creditworthiness has improved for idiosyncratic reasons—the borrower will still be deterred from refinancing, unless those expected savings are also greater than the fixed fee.[18]

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[18] If the borrower's expected savings are *not* greater than the fixed fee, but are greater than the lender's damages from prepayment, the lender may still permit prepayment, but only in exchange for a share of the difference between its expected damages and the borrower's expected savings. *See* Whitman, *supra* note 1, at 876–78. As applied to prepayment fees, the Coase Theorem suggests that, where a fixed fee will exceed the

2. Yield Maintenance Formulas

The other major category of prepayment fees is composed of fees based on so-called yield maintenance formulas ("YMFs"). YMFs, unlike fixed prepayment fees, are intended to estimate the actual damages to the lender resulting from prepayment.

YMFs, which are sometimes described as "makewholes," come in various forms. One type of YMF is in substance indistinguishable from a no call. It would provide, for example, that the lender's makewhole is equal to "the difference between (a) the interest income [the lender] would have earned had the contract been performed, and (b) the interest income [the lender] would be deemed to have earned by timely mitigating its damages."[19] If enforced, such a YMF would effectively ensure that a court does not enjoin prepayment and applies the standard formula for determining expectation damages. Otherwise, it is functionally no different from a no call.

Another type of YMF simplifies the calculation of actual damages by fixing the lender's reinvestment rate *ex ante*. In some cases, loan parties have fixed the reinvestment rate at the rate of interest that could be obtained through investment in a U.S. Treasury note of a maturity similar to that of the relevant loan.[20] Because the interest rates on commercial loans are invariably higher than treasury rates, the effect of using a treasury rate as a reference is that damages will be payable to lenders under such a formula even when interest rates on similar loans have not changed or have even gone up. As a result, when a lender is able to reinvest absent material transaction costs, use of a treasury rate as a reference overcompensates the lender for lost yield. An alternative approach, which reduces the risk of such overcompensation, is to use a reference *other* than treasuries—such as (i) average interest rates on loans with the same credit rating, (ii) a lender's internal index for loans within the same industry, or (iii) a fixed spread above treasuries. In practice, such YMFs are relatively rare, whereas YMFs that use a treasury reference are common.[21]

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borrower's expected savings by x and the lender's actual damages by x+y, the parties will negotiate to split y so that the prepayment can go forward, at least in a world without transaction costs. *Id*. The alternative, which is less beneficial to each party, is that no prepayment takes place.

[19] This is the formula used in one of the *Teachers* cases to determine the damages resulting from breach of a no call. *See* 799 F. Supp. at 19.

[20] *E.g.*, River East Plaza, LLC v. Variable Annuity Life Ins. Co., No. 06-3856, 2007 WL 2377383, at *1 (7th Cir. Aug. 22, 2007); *In re* Skyler Ridge, 80 B.R. 500, 502 (Bankr. C.D. Cal. 1987).

[21] Commentators have disagreed as to whether it is practicable to use a reference other than treasuries to determine a lender's projected reinvestment rate. Some commentators have suggested that treasury rates are properly used, at least in the mortgage context, "because there exists no standard commercial mortgage loan rate, given the uniqueness of each commercial loan and the inherent difficulty (if not impossibility) of identifying an identical or similar loan." Richard F. Casher, *Prepayment Premiums: Hidden Lake is a Hidden Gem*, 19 AM. BANKR. INST. J., Nov. 2000, at 32. *See* Debra P. Stark, *Prepayment Charges in Jeopardy: The Unhappy and Uncertain Legacy of In re Skyler Ridge*, 24 REAL PROP., PROB. & TRAN. J. 191, 196 (1989) (noting that there is no "standard" index of commercial mortgage loan rates and that it may be

YMFs are usually used in fixed-rate loan agreements because, as long as they are not *under*compensatory, they perfectly protect a lender from a decline in market rates—the critical risk posed to fixed-rate lenders. Fixed prepayment fees, on the other hand, would leave a fixed-rate lender vulnerable to any decline in interest rates that exceeds the amount of the fee.

In contrast to YMFs, fixed prepayment fees are usually used in floating-rate loan agreements. Since a borrower under a floating-rate facility derives no benefit from prepayment *except* when prepayment is efficient regardless of changes in market rates, a fee tied to market rates generally will not deter prepayment under such a facility. A fixed prepayment fee, on the other hand, *will* deter prepayment under a floating-rate facility as long the borrower's projected savings are below the amount of the fee. A fixed prepayment fee also ensures that the lender will receive some compensation for taking the risks associated with reinvestment.[22]

II. PREPAYMENT CLAUSES AND ACCELERATION

Section 101(5)(A) of the Bankruptcy Code defines a "claim" as any right to payment. Section 502(b)(1) states that a court "shall allow" a claim except 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 unmatured; [or] (2) such claim is for unmatured interest." Under the Bankruptcy Code, therefore, a claim for the *principal* amount of a loan is allowed against a debtor even if that amount is not yet due and owing.

"impossible" for a lender to find a loan with similar characteristics). Other commentators have criticized these arguments; according to Whitman, a "reasonable measure" of damages can be derived simply by using a lender's internal index for all commercial mortgage loans. *See* Whitman, *supra* note 1, at 898–99; *accord* Edythe L. Bronston, *The Enforceability of Prepayment Premiums in Bankruptcy Court*, 18 CAL. BANKR. J. 54, 58 (1990) (suggesting prepayment fee formulas should "subtract the lender's present offered rate on similar loans from the contractual rate on the prepaid loan, multiply that by the principal balance on the loan, and provide a premium equal to the present discounted value of that payment stream"); David S. Kupetz, *The Bankruptcy Code Is Part Of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 BUS. LAW. 55, 81 & n.110 (1998) (agreeing with Bronston's approach). In the commercial loan context, where objective measures such as agency ratings may be available, the argument for a proxy other than treasury rates has additional force.

[22] This article does not deal with defeasance provisions—*i.e.*, provisions in a loan agreement that permit borrowers to retire debt prior to its scheduled maturity, but only if they purchase Treasury obligations for the lenders' benefit that match the projected cash flow of remaining principal and interest payments under the loan agreement. For an overview and analysis of such provisions, see George Lefcoe, *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment*, 28 REAL EST. L.J. 202 (Winter 2000). Defeasance provisions are favorable to lenders because they protect a lender's expected income stream without requiring reinvestment in a loan with a meaningful default risk. *Id.* at 207. They are less favorable to borrowers because, even when a lender would suffer no damages from prepayment (because reinvestment will produce the same yield as the original instrument), the borrower still has the obligation to purchase Treasuries for the lenders' benefit. *Id.* at 203–04. In bankruptcy, defeasance provisions have been held to be inapplicable because, among other things, loan agreements typically provide that such provisions are inoperative in default situations. *See In re* Calpine Corp., 365 B.R. 392, 399 (Bankr. S.D.N.Y. 2007); *accord In re* Solutia Inc., No. 03-17949, 2007 WL 3376900, at *12 (Bankr. S.D.N.Y. Nov. 9, 2007) (embracing *Calpine*'s reasoning).

Based on section 502(b)(1), courts have concluded that bankruptcy "operates as the acceleration of the principal amount of all claims against the debtor."[23] Many loan agreements compel the same result, as they provide that the borrower's bankruptcy filing is an event of default upon which the loans accelerate automatically without further action by the lenders. The question that has arisen in various bankruptcy cases, and which is discussed here, is whether contractual provisions governing the voluntary prepayment or redemption of debt have any further application once a loan's maturities have accelerated automatically, such that repayment is not necessarily "voluntary" and arguably may not be a "*pre*payment" at all. If such provisions are no longer operative in bankruptcy, their enforceability under sections 502(b) and 506(b) of the Bankruptcy Code is academic.

At the outset, it is crucial to emphasize that any rule under which acceleration precludes enforcement of a prepayment clause is no more than a default rule. If parties to a loan agreement expressly agree that a prepayment fee will be payable upon or after acceleration, that agreement will be respected by courts inside and outside of bankruptcy.[24] To a large extent, therefore, a lender controls its destiny. If a lender and borrower agree to include a provision in their loan documents under which a prepayment fee is payable as long as the loan's *original* maturity dates have not passed, any possible tension between the fee and acceleration evaporates. The lender is then assured that it will be compensated for prepayment (to the extent permitted by bankruptcy law) if the borrower files.

This discussion, therefore, is necessarily limited to a subset of cases, *i.e.*, those in which a loan agreement does not address the effect of acceleration on the agreement's prepayment clause.

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[23] *E.g.*, *In re* Tonyan Constr. Co., 28 B.R. 714, 727 (Bankr. N.D. Ill. 1983) (citing legislative history of section 502(b)); *accord In re* Manville Forest Prods. Corp., 43 B.R. 293, 297 (Bankr. S.D.N.Y. 1984) (citing numerous cases), *aff'd in part, rev'd in part on other grounds*, 60 B.R. 403 (S.D.N.Y. 1986).

[24] *See In re* CP Holdings, Inc., 206 Fed. Appx. 629, 630 (8th Cir. 2006) (enforcing prepayment fee triggered by acceleration); *In re* AE Hotel Venture, 321 B.R. 209, 218 (Bankr. N.D. Ill. 2005) ("Parties to loan agreements may . . . agree that prepayment premiums are due even after acceleration."); *In re* Hidden Lake Ltd. P'ship, 247 B.R. 722, 728–30 (Bankr. S.D. Ohio 2000) (enforcing prepayment fee triggered by acceleration); *In re* Fin. Ctr. Assocs., 140 B.R. 829, 834–35 (Bankr. E.D.N.Y. 1992) (rejecting argument that acceleration waived prepayment charge where agreement provided for charge even after acceleration); *In re* Schaumburg Hotel Owner Ltd. P'ship, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989) (declaring prepayment fee enforceable upon acceleration where creditor bargained for clause allowing both acceleration and collection of prepayment fee upon default); *see also* Randall D. Crocker & Anne F.B. Weissmueller, *Prepayment Provisions in Bankruptcy: Premiums or Penalties?*, AM. BANKR. INST. J., Feb. 2007, at 26 (noting trend in favor of enforcing prepayment provisions upon acceleration where parties' agreement provides for prepayment fee in that circumstance); Nation, *supra* note 11, at 641 (arguing prepayment fees should be enforced upon acceleration if parties' agreement so provides) ("[T]he lender and the borrower have agreed to allocate the lender's risk from early payment . . . . caused by any events that are defined as events of default, including those that may be beyond the borrower's control.").

A. Purposeful Acceleration

The first scenario in which the relationship between acceleration and prepayment has been tested, both inside and outside of bankruptcy, is that in which a lender *elects* to accelerate a debt in response to a default. In such situations, courts have generally held that the lender forfeits any contractual right it might have to a prepayment fee.[25] This result follows from the language of most prepayment provisions, under which a fee is payable or debt is non-callable only if a repayment is "voluntary" or "optional." Once a lender opts to accelerate a loan's maturities after a default, repayment of the loan is neither "voluntary" nor "optional" and arguably is not a "*pre*payment" at all, but rather a payment of debt that has matured.[26] In bankruptcy, the result is no different: If a lender attempts to coerce immediate repayment of a debt notwithstanding the automatic stay (for example, by seeking relief from the stay), there is a strong argument that the lender has waived whatever entitlement it may have had to collect a fee or damages on account of a voluntary prepayment.[27]

A second scenario in which the relationship between prepayment clauses and acceleration has been tested is that in which a *borrower* purposely defaults under a loan agreement in order to avoid the effect of the agreement's prepayment clause. The Second Circuit considered the problem of a borrower's purposeful default in *Sharon Steel Corp.* v. *Chase Manhattan Bank, N.A.*[28] In that case, a borrower sold less than "all or substantially all" of its assets to a third party, triggering a provision in its indentures under which all debts became immediately due and payable. However, rather than redeeming the debts in full, and paying the indentures' fixed prepayment fee, the debtor defaulted on its redemption obligation. The debtor then asserted that, because the default permitted the bondholders to accelerate the debt,

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[25] *See, e.g.*, 3C Assocs. v. IC & LP Realty Co., 524 N.Y.S.2d 701, 702 (App. Div. 1988) (holding lender that brought foreclosure action could not collect prepayment fee); Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831, 835–36 (N.Y. Sup. Ct. 2006); *see also In re* Duralite Truck Body & Container Corp., 153 B.R. 708, 715 (Bankr. D. Md. 1993) ("Where the lender has exercised its option to accelerate upon default, the economic justification for a prepayment premium as alternative performance of the bargained loan is negated."); *In re* Pub. Serv. Co. of N.H., 114 B.R. 813, 818 (Bankr. D.N.H. 1990) ("It is uniformly recognized that prepayment premiums are generally not enforceable when 'waived' by acceleration demands or other conduct indicating immediate cash payment is desired."); *In re* Planvest Equity Income Partners IV, 94 B.R. 644, 645 (Bankr. D. Ariz. 1988) ("Acceleration of a note is recognized as preventing the mortgagee from seeking to enforce a prepayment penalty clause.").

[26] *See In re* LHD Realty Corp., 726 F.2d 327, 330–31 (7th Cir. 1984) ("[A]cceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity." (citation omitted)); Slevin Container Corp. v. Provident Federal Savings & Loan Ass'n, 424 N.E.2d 939, 941 (Ill. App. Ct. 1981) ("[T]he election [to accelerate] renders the payment made pursuant to the election one made after maturity and by definition not prepayment.").

[27] For bankruptcy cases recognizing that a lender's election to accelerate or other conduct aimed at collecting immediate payment amounts to a waiver of any right to a "voluntary prepayment" fee, see, for example, *Duralite Truck Body & Container Corp.*, 153 B.R. at 715; and *Pub. Serv. Co. of N.H.*, 114 B.R. at 818; *Planvest Equity Income Partners IV*, 94 B.R. at 645.

[28] 691 F.2d 1039 (2d Cir. 1982).

the bondholders were not entitled to a prepayment fee. The Second Circuit disagreed. Noting that "[t]his is not a case in which a debtor finds itself unable to make required payments," the court perceived "no bar . . . to the Indenture Trustees seeking specific performance of the redemption provisions where the debtor causes the debentures to become due and payable by its voluntary actions."[29] Crucially, however, the acceleration provisions in *Sharon Steel* were "explicitly permissive"; in other words, it was up to the bondholders alone to decide whether to accelerate in response to a default. Since they did not do so, but elected instead to collect their prepayment fee, the debtor maintained its obligation to pay that fee.

The logic of *Sharon Steel* is hard to contest. First, the redemption of debt after a purposeful default, but absent an election by a lender to accelerate, is fundamentally no different from prepayment in the absence of any default. In that situation, there is no basis to argue either that the repayment of debt is involuntary (there has been no coercion) or that the payment is a *pre*payment (there has been no acceleration of maturities). Moreover, as a matter of good faith and fair dealing, a purposeful default aimed solely at depriving a lender of a prepayment fee is repugnant, and should not be given effect.

B. Automatic Acceleration

The automatic acceleration that results from a bankruptcy filing poses a special problem. In that circumstance, unlike in cases in which a lender elects to accelerate, a debtor cannot reasonably assert that the lender has waived its entitlement to a prepayment fee. At the same time, unlike in cases in which a non-bankrupt borrower purposely defaults but the lender eschews acceleration in favor of a prepayment fee, bankruptcy acceleration is *automatic*; thus, as a contractual matter, lenders have little basis to claim, as they did in *Sharon Steel*, that they can still choose their remedy.[30]

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[29] *Id.* at 1053; *see also Nw. Mut.*, 816 N.Y.S.2d at 836 ("In the event that a court concludes that the borrower has defaulted intentionally in order to trigger acceleration and thereby avoid or evade a prepayment premium, the prepayment clause may be enforced, notwithstanding substantial authority which requires an explicit agreement to allow a premium after acceleration.").

[30] The concept of "automatic" acceleration—*i.e.*, acceleration based on the occurrence of an event other than an election to accelerate—is not entirely unique to bankruptcy. There is some non-bankruptcy law that supports the conclusion that automatic acceleration provisions are not "self operative," but instead have to be invoked by the lender. For example, in *Tymon* v. *Wolitzer*, a New York trial court held that a provision under which debts became due and owing without notice as a result of certain defaults "could be brought into being only by an election to accelerate affirmatively exercised by the []obligees." 240 N.Y.S.2d 888, 896 (N.Y. Sup. Ct. 1963). The court reasoned that "[a]ny other holding would take the option of accelerating away from the pledgee for whose benefit the clause is placed in the contract and give it to the pledgor," thus allowing a borrower to default deliberately and "compel an obligee to accept immediate payment of the debt contrary to the intention of the parties and to the detriment of the obligee." *Id.*; *accord* Wurzler v. Clifford, 36 N.Y.S.2d 516, 518 (N.Y. Sup. Ct. 1942).

1. Case Law

The universe of cases addressing the effect of a bankruptcy filing on prepayment fees is surprisingly small. The cases that do exist have generally concluded that, as stated in *In re Skyler Ridge*, "[t]he automatic acceleration of a debt upon the filing of a bankruptcy case is not the kind of acceleration that eliminates the right to a prepayment premium."[31] But they have done so for different reasons. In *Skyler Ridge*, the court refused to find that the automatic acceleration resulting by operation of law from a bankruptcy filing defeats enforcement of a prepayment fee clause because, if that were the law, a debtor could "avoid the effect of [such a] clause by filing a bankruptcy case"—a result that the court believed was "drastic" and unfair to lenders.[32]

In *In re Imperial Coronado Partners, Ltd.*, the Bankruptcy Appellate Panel for the Ninth Circuit reached the same conclusion as the *Skyler Ridge* court—that a chapter 11 debtor may not escape a contractual prepayment fee simply by filing for bankruptcy protection—but on different grounds.[33] In *Coronado Partners*, a lender initiated foreclosure proceedings against its borrower by declaring the borrower's debt to be due and owing after the borrower missed an interest installment. In response, the borrower filed a voluntary chapter 11 petition, successfully opposed the lender's motion for relief from the automatic stay to continue the foreclosure, and subsequently obtained court approval for a property sale that allowed the lender's debt to be paid in full. The borrower objected, however, to the payment of a prepayment fee equal to six months interest on the prepaid amount.[34]

Rejecting the contention that the lender's acceleration of the note meant that the borrower could no longer "prepay" the note, the bankruptcy court concluded that the prepayment fee clause in the loan agreement should be enforced. The court focused on the borrower's legal authority to "deaccelerate" its debt:

> Many courts have held that where a mortgagee accelerates the amount due under a note, a prepayment penalty may not be collected. In those cases, however, it appears that the borrower had no choice but to pay the accelerated amount or lose the property . . . . The situation in the case at bar is different because [the borrower] had the right to reinstate the loan under California law or to

[31] *In re* Skyler Ridge, 80 B.R. 500, 507 (Bankr. C.D. Cal. 1987).

[32] *Id.* at 507. The loan agreement at issue in *Skyler Ridge* contained a no call that prohibited prepayment for the first two years of the loan. However, the lenders, rather than seeking enforcement of the no call, sought only to collect the prepayment fee that would be payable *after* the first two years. 80 B.R. at 502. Before dealing with acceleration, the court concluded that the formula used by the parties to calculate the fee was not "reasonable" under state law or section 506(b) of the Bankruptcy Code. *Id.* at 507. The discussion of acceleration, therefore, is dicta.

[33] 96 B.R. 997 (B.A.P. 9th Cir. 1989).

[34] *Id.* at 998–99.

> deaccelerate the loan under bankruptcy law. . . . Under the Bankruptcy Code, [the borrower] had the right to deaccelerate the due date of the loan as part of a plan of reorganization. *See* 11 U.S.C. § 1124(2).[35]

In response to the debtor's argument that it had not *exercised* its "deacceleration" right under the Bankruptcy Code, the court explained:

> With respect to deacceleration, [the borrower] assessed its situation and decided that selling the property under § 363 was a better business decision than attempting to refinance the property and deaccelerate the loan as a part of a reorganization plan. As [the borrower] admits, this was a conscious decision on its part. In our view, the decision to sell the property and pay off the loan was voluntary, and the prepayment premium is therefore enforceable.[36]

Thus, whereas the *Skyler Ridge* court emphasized that a borrower should not be able to avoid a prepayment fee at its option, the *Coronado Partners* court concluded that repayment of a debt the maturities of which could be deaccelerated was necessarily "voluntary."[37]

Recently, the Bankruptcy Court for the Southern District of New York, in a decision arising out of the Calpine bankruptcy, apparently agreed with *Skyler Ridge* and *Coronado Partners* that the automatic acceleration of a debt does not preclude its "voluntary prepayment" in breach of a loan agreement.[38] *Calpine* involved various loan agreements under which the borrower's bankruptcy filing constituted an event of default that automatically accelerated the loans. Some of the same agreements, however, prohibited any voluntary prepayment.[39] The Court agreed with the debtor that, as a result of the Calpine bankruptcy filings, the debts at issue

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[35] *Id.* at 1000 (citations omitted). Section 1124(2) of the Bankruptcy Code provides that, notwithstanding an acceleration clause in a loan agreement, a creditor's claim is not impaired if, in a plan of reorganization, the debtor cures any defaults under the loan agreement, reinstates the loan's original maturities, compensates the creditor for any damages incurred as a result of "reasonable reliance" on an acceleration clause, and does not otherwise alter the creditor's rights. *See* 11 U.S.C. § 1124(2) (2006). Where loans have not yet reached their original maturity date, courts have held that a borrower is legally entitled to "deaccelerate" those maturities under section 1124(2). *E.g., In re* Liberty Warehouse Assoc. Ltd., 220 B.R. 546, 549 (Bankr. S.D.N.Y. 1998); *In re* Ace-Texas, Inc., 217 B.R. 719, 727 (Bankr. D. Del. 1998).

[36] *Coronado Partners*, 96 B.R. at 1000.

[37] *Id*. at 999–1000. At least one other court has adopted the reasoning of *Coronado Partners*. In *In re 433 S. Beverly Drive*, the Bankruptcy Court for the Central District of California compelled a debtor to pay a prepayment fee even though the lender had accelerated the loan the day before the borrower filed. 117 B.R. 563, 568 (Bankr. C.D. Cal. 1990). The Court emphasized, as in *Coronado Partners*, that the debtor's filing freed the debtor to reinstate its loans under section 1124(2) of the Bankruptcy Code. *Id.*

[38] *In re* Calpine Corp., 365 B.R. 392 (Bankr. S.D.N.Y. 2007) (Lifland, J.). As of this writing, both the debtor and the lenders have appealed the Bankruptcy Court's decision, the debtor on the basis that no damages should have been awarded to lenders and the lenders on the basis that the damages awarded were not fully compensatory and should have been treated as a secured claim.

[39] *Id*. at 397.

had become "due and payable immediately."[40] Nonetheless, the Court also concluded that the lenders were entitled to an unsecured claim for damages resulting from prepayment.[41] Although the Court did not specifically explain why the post-acceleration repayment of debt was a "voluntary prepayment," the inescapable premise of its decision to award damages is that the payment of accelerated debt was a voluntary prepayment for which the lenders had to be compensated.[42]

2. Analysis of Case Law

Of the two rationales offered for treating the repayment of accelerated debt in bankruptcy as a "voluntary prepayment"—the *Skyler Ridge* court's and the *Coronado Partners* court's—the latter is the stronger one. The *Skyler Ridge* court's contention that a debtor could always avoid a prepayment fee by filing for bankruptcy protection if automatic acceleration were deemed to preclude such a fee does not account for modern loan agreements, which often state that prepayment fees will be payable upon or after acceleration. By insisting that a loan agreement provide for a prepayment fee notwithstanding acceleration, a lender can avoid the one-way ratchet described in *Skyler Ridge*.[43]

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[40] *Id*. at 398.

[41] *Id*. at 399.

[42] In *Granite Broadcasting*, another bankruptcy court in the Southern District of New York indicated that it would probably enforce a prepayment fee notwithstanding the automatic acceleration that follows from a bankruptcy filing. In that case, certain pre-petition equityholders objected to a plan that awarded new equity to secured creditors, claiming that the plan undervalued the debtor's business and therefore paid the secured lenders more than the value of their claims. 369 B.R. 120, 143 (Bankr. S.D.N.Y. 2007). The preferred equityholders also proposed an alternative plan that would pay secured creditors in full *without* a contractual prepayment fee. *Id.* En route to concluding that the equityholders' plan was infeasible because it would overload the reorganized company with debt, the court stated in dicta that, unlike purposeful acceleration, "the automatic acceleration of debt occasioned by a bankruptcy filing may not result in a forfeiture" of a prepayment fee. *Id*. at 144.

As this article went to press, a separate bankruptcy court in the Southern District of New York departed from *Calpine*, and concluded that the automatic acceleration of a debt resulting from a bankruptcy filing *does* prevent a lender from collecting damages or a fee for "prepayment." In *In re Solutia Inc*., No. 03-17949, 2007 WL 3376900, at *11 (Bankr. S.D.N.Y. Nov. 9, 2007), noteholders invoked the decision in *Calpine* to argue that, notwithstanding the automatic acceleration of their debt under the relevant loan documents, they were entitled (based on the rule of perfect tender and the absence of a fixed prepayment fee) to receive interest at the contract rate through the original maturity date. The court disagreed, finding instead that because the notes at issue were automatically accelerated, "any payment at this time would not be a prepayment." *Id.* While acknowledging the rule of perfect tender, the court reasoned that "[b]y incorporating a provision for automatic acceleration, the [n]oteholders made a decision to give up their future income stream in favor of having an immediate right to collect their entire debt." *Id.* The court thus specifically rejected the decision in *Calpine* on the basis that it impermissibly "reads into" the loan agreement a provision that permits prepayment damages to be awarded even after acceleration. *Id.* at *9. As of this writing, the noteholders have moved for reconsideration of the *Solutia* decision.

[43] *See* Hillinger, *supra* note 6, at 462 ("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.").

The court's reasoning in *Coronado Partners* has more force, at least in cases in which the debtor is simply seeking to refinance its debt on more favorable terms. As a general matter, a chapter 11 debtor that has the capacity to refinance secured debt on better terms also has the wherewithal to deaccelerate that debt and, if the loans have not reached their original maturities, unimpair the creditors that hold it. Under the protection of the automatic stay, such a debtor is in the same position within bankruptcy as it would be outside bankruptcy, and cannot reasonably assert that its repayment of debt is not "voluntary." If redemption in such circumstances *were* considered involuntary, the debtor would effectively have an option for which it did not bargain: It could deaccelerate if interest rates go up, thus depriving a lender of the opportunity to reinvest at higher interest rates, but it could repay without penalty if interest rates go down, thus forcing the lender to reinvest at lower interest rates without receiving a prepayment fee. The insight of *Coronado Partners* is that, because the Bankruptcy Code gives a debtor the power to maintain its capital structure notwithstanding curable defaults, any decision to alter that capital structure is not "compelled" by the acceleration attendant to bankruptcy.

Given its emphasis on voluntariness, *Coronado Partners* is less persuasive as applied to cases in which deacceleration is infeasible or lenders seek to coerce immediate payment. It is unclear, for example, why the power to deaccelerate should render a repayment "voluntary" when deacceleration is not a practical possibility. It is also unclear why a lender's pre-bankruptcy election to accelerate should not be treated as a waiver of the lender's right to collect a prepayment fee; although the automatic stay may protect the borrower from foreclosure in that circumstance, that does not change the fact that the lender had sought to compel repayment prior to maturity.[44] The logic of *Coronado Partners*, in sum, is most persuasive as applied to situations in which the "voluntariness" of the decision not to deaccelerate is not subject to question based on either the debtor's options or the lender's actions.

Coronado Partners and the other cases cited are open to scrutiny not only for their broad conception of "voluntariness" but also for failing to grapple with the literal meaning of the word "prepayment." Where a contractual provision imposes a fee for voluntary "*redemption*," it is hard to dispute that the provision should apply to a mid-case refinancing aimed at exploiting better borrowing conditions. In that situation, since the borrower has the option to deaccelerate and enjoys the protection of the automatic stay, such a "redemption" would indisputably be "voluntary." However, altering the language of a provision to apply to "voluntary *prepayments*," as opposed to "voluntary *redemptions*," arguably complicates the analysis. Under one potential view, a repayment of a debt that is technically

[44] These are among the arguments made by Judge Mooreman in his dissent from the majority opinion in *Coronado Partners*. *See* 96 B.R. at 1001–02 (Mooreman, J., dissenting). Judge Mooreman questioned the majority's conclusion that the power to deaccelerate *necessarily* makes a payment "voluntary" even when deacceleration is implausible. *Id.* at 1001. He likewise questioned the majority's conclusion that the lenders had not waived their right to a "voluntary" prepayment by seeking relief from the stay to foreclose. *Id.* at 1002.

accelerated cannot, by definition, be a *pre*payment.[45] The strength of this contention depends in part on whether "prepayment" is interpreted to mean payment before a loan's *original* maturity date or payment before its *accelerated* maturity date. Although the *Skyler Ridge* and *Coronado Partners* courts did not expressly address this issue, each of those courts apparently adopted the former interpretation. The fact that many loan agreements will assess a "prepayment" fee even after acceleration supports these courts' position, as it suggests that sophisticated parties view "prepayment" as a term of art meaning payment before an *original* maturity date.[46] The fact that payments voluntarily made during a chapter 11 case are necessarily made prior to the date on which they are "due" as a matter of bankruptcy law—at the earliest, the date that a plan of reorganization goes into effect—further supports these courts' position.

On the other hand, interpreting "prepayment" to mean payment before a loan's *original* maturity date is difficult to reconcile with the case law stating that a lender's election to accelerate necessarily precludes a prepayment fee. If a contract provision requires a "voluntary prepayment," the "voluntariness" requirement is enough to ensure that a lender waives any prepayment fee by attempting to coerce prepayment. If a provision merely refers to "prepayment," however, and if "prepayment" is interpreted to mean payment before a loan's *original* maturity date, a lender's election to accelerate would not necessarily prevent collection of a prepayment fee—a result that does not comport with some precedents.[47]

3. Additional Considerations

The courts have not focused on two additional issues that bear on the relationship between acceleration and prepayment—(1) the distinction between acceleration by law and acceleration by contract, and (2) the possibility that

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[45] *See In re* LHD Realty Corp., 726 F.2d 327, 330–31 (7th Cir. 1984) ("[A]cceleration, by definition, advances the maturity date of the debt so payment thereafter is not prepayment but instead is payment made after maturity."); Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831, 834 (N.Y. Sup. Ct. 2006) ("'Prepayment' is a payment before maturity. 'Acceleration' is a change in the date of maturity from the future to the present. Once the maturity date is accelerated to the present, it is no longer possible to prepay the debt before maturity. Any payment made after acceleration of the maturity date is payment made *after* maturity, not before." (emphasis in original) (quoting Rodgers v. Rainier Nat'l Bank, 111 Wash. 2d 232, 237, 757 P.2d 976 (1988)).

[46] For discussion of contract provisions permitting prepayment fees to survive acceleration, see, for example, *In re* AE Hotel Venture, 321 B.R. 209, 218 (Bankr. N.D. Ill. 2005), and *In re* Fin. Ctr. Assocs., 140 B.R. 829, 834–35 (Bankr. E.D.N.Y. 1992).

[47] *E.g.*, *LHD Realty Corp.*, 726 F.2d at 330–31 ("[T]he lender loses its right to a premium when it elects to accelerate the debt. This is so because acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity." (internal citations omitted)); Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n of Peoria, 424 N.E.2d 939, 941 (Ill. App. 1981) ("We believe where the discretion to accelerate the maturity of the obligation is that of the obligee, the exercise of the election renders the payment made pursuant to the election one made after maturity and by definition not prepayment.").

automatic acceleration provisions in loan agreements are unenforceable as *ipso facto* clauses.

a. Legal versus Contractual Acceleration

The often-overlooked distinction between acceleration by law and acceleration by contract raises additional doubt as to whether a *non*-contractual acceleration of debt should be viewed as precluding a prepayment fee. The rationale for treating debts as accelerated by *law* as a result of a bankruptcy filing was explained in *In re Manville Forest Products Corp.*[48] There, the Bankruptcy Court for the Southern District of New York noted that a bankruptcy filing's acceleration of debts "follows logically from the expansive Code definition of 'claim', which allows any claim to be asserted against the debtor, regardless of whether such claim is [unmatured], and from the Code's provision in Section 502 that a claim will be allowed in bankruptcy regardless of its contingent or unmatured status."[49] These provisions of the Code, according to the *Manville* court, make clear that claims for unmatured principal amounts may be asserted against a debtor in a proof of claim without violating the automatic stay. However, they do not modify the automatic stay for other purposes.[50]

The legal acceleration resulting from a bankruptcy filing, therefore, appears to be relatively limited. Since debts are "accelerated" only in the sense that lenders can file a proof of claim for unmatured principal amounts, those amounts are not necessarily due and owing for purposes of a provision restricting or regulating prepayment. Contractual acceleration, on the other hand, is not so limited. Although automatic acceleration provisions in loan agreements may simply be intended to memorialize the rule explained in *Manville*, most acceleration provisions broadly state that the borrower's debts are accelerated upon a bankruptcy filing. In addition, since such clauses allow prompt enforcement of guarantees and accrual of default-rate interest, their effects clearly go beyond permitting a creditor

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[48] 43 B.R. 293 (Bankr. S.D.N.Y. 1984), *aff'd in part, rev'd in part on other grounds*, 60 B.R. 403 (S.D.N.Y. 1986).

[49] *Id.* at 297; *see, e.g., In re* Express Freight Lines, Inc., 130 B.R. 288, 293 (Bankr. E.D. Wis. 1991) ("[T]he filing of a bankruptcy petition acts to accelerate the debtor's debt . . ."); *In re* Tonyan Constr. Co., 28 B.R. 714, 727 (Bankr. N.D. Ill. 1983) (bankruptcy filing operates to accelerate obligation to repay principal amounts of debt); *In re* Princess Baking Corp., 5 B.R. 587, 590 (Bankr. S.D. Cal. 1980) ("[B]ankruptcy proceedings operate to accelerate the principal amounts of all claims against the debtor, with the result that setoff may be asserted even though one of the debts involved is absolutely owing, but not then presently due.").

[50] *Manville Forest Prods. Corp.*, 43 B.R. at 298 n.5 ("While the Court today holds that sending a notice of acceleration is unnecessary to file a claim against a debtor for the entire amount of the debt, despite the actual maturity date or the terms of the contract, this does not apply where notice is required as a condition precedent to establish other substantive contractual rights such as the right to receive a post-default interest rate."); *see In re* PCH Assocs., 122 B.R. 181, 198 (Bankr. S.D.N.Y. 1990) (noting "distinction between acceleration of a debt upon the filing of the bankruptcy petition for the purpose of the filing of a proof of claim in a case . . . and acceleration for the purpose of taking actions against a debtor in violation of the automatic stay").

to file a claim for unmatured principal. The tension between acceleration and prepayment, therefore, is strongest when the lender has agreed by contract that debts mature upon a bankruptcy filing.

b. Acceleration Clauses as Ipso Facto *Clauses*

An additional question that has not been widely considered is whether section 365(e)(1) of the Bankruptcy Code,[51] which prevents enforcement of clauses in executory contracts that modify a borrower's rights based solely on a bankruptcy filing, might preclude the enforcement of provisions in loan agreements that provide for automatic acceleration upon a bankruptcy default.

Based on a straightforward reading of the Bankruptcy Code, it would appear that section 365(e)(2)(B) settles the issue. That provision excludes from the scope of section 365(e)(1) any "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."[52] In several decisions, however, bankruptcy courts have concluded that section 365(e)(2)(B) applies only to agreements to extend *future* credit to a debtor, not to agreements under which credit has already been extended.[53] These cases rely on a statement in the legislative history of section 365(c)(2) of the Code, under which a trustee may not assume or assign a "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." With respect to section 365(c)(2), the House Judiciary Committee report states that "the purpose of this subsection, at least in part, is to prevent the trustee from requiring new advances of money or other property."[54] Based on this statement, courts have concluded that section 365(e)(2)(B) does not apply, and thus section 365(e)(1) applies, to loan agreements that do not require the extension of future credit.[55]

The courts' reliance on the House Report is open to question. Although the Report suggests that Congress was concerned about the assumption of agreements under which future credit has to be extended, it is hard to understand how it proves that either section 365(c)(2) or section 365(e)(2)(B) applies *only* insofar as post-petition credit obligations are concerned. On their face, both provisions apply categorically to entire loan contracts, not just contracts or provisions under which future credit must be extended.

Further, even if 365(e)(2)(B) applies only to executory commitments to extend future credit, as stated in *Texaco*, section 365(e)(1) still does *not* apply to contracts other than "executory contracts" and unexpired leases. In *Texaco*, the court concluded that a note indenture was executory under the "Countryman definition"

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[51] 11 U.S.C. § 365(e)(1) (2006).

[52] 11 U.S.C. § 365(e)(2)(B).

[53] *In re* Texaco, Inc., 73 B.R. 960, 965 (Bankr. S.D.N.Y. 1987); *In re* Peninsula Int'l Corp., 19 B.R. 762, 764 (Bankr. S.D. Fla. 1982).

[54] H.R. REP. NO. 95–595, at 348 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304–05.

[55] *In re* Schewegmann Giant Supermarkets, 287 B.R. 649, 657 (E.D. La. 2002) (applying section 365(e)(1) to invalidate automatic acceleration clause in loan agreement); *Texaco*, 73 B.R. at 965.

of an executory contract—*i.e.*, "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other."[56] As evidence of the "executoriness" of the indenture, the *Texaco* court pointed to, among other things, the trustee's continuing obligation to tender notices of default to the debtor and to deliver status reports to noteholders.[57] The *Texaco* court did not consider, however, whether a breach of these particular obligations would be sufficiently material to justify non-performance by the debtor. The court also glossed over the fact that the obligations it identified were obligations of the indenture trustee to the *noteholders* rather than the debtor; thus, even if such obligations were material, it is unclear how their breach could excuse the *debtor* from meeting its obligations to the trustee. Although a full discussion of "executoriness" is beyond the scope of this article, there is clearly room for dispute as to whether the types of obligations identified by the *Texaco* court are sufficient to make a loan agreement executory.

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Until the relationship between acceleration and prepayment clauses is resolved, or the loan agreements that do not explicitly address that problem pass out of existence, courts will continue to grapple with whether the acceleration attendant to bankruptcy filing precludes enforcement of a prepayment clause. For lenders seeking to protect their yield in bankruptcy, the optimal strategy is to negotiate a provision that requires the borrower to pay a prepayment fee whenever debt is repaid prior to its *original* maturity. Otherwise, although there is some precedent under which a lender that elects to accelerate a loan's maturities can still collect a prepayment fee in bankruptcy (on account of the debtor's power to deaccelerate), a lender seeking to preserve its right to collect such a fee is on the strongest ground if it takes no action to coerce payment of outstanding principal.

III. PREPAYMENT CLAUSES AND OVERSECURED CREDITORS

If a prepayment clause is operative notwithstanding acceleration, that does not necessarily mean that the right to payment arising from the clause must be included in a lender's allowed claim. To determine whether a prepayment clause gives rise to an allowed claim, a court needs to apply the claims allowance provisions of the Bankruptcy Code. The Code defines a "claim" as a "right to payment,"[58] and requires a bankruptcy court, upon objection, to disallow claims to the extent they

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[56] *Texaco*, 73 B.R. at 964 (relying on Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973)).

[57] *Id.*

[58] 11 U.S.C. § 101(5) (2006).

are unenforceable "under any agreement or applicable law."[59] Section 506(a)(1) distinguishes between allowed unsecured claims and allowed secured claims, providing that "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest" in such property.

Section 506(b) deals exclusively with the claims of *over*secured creditors. It provides that "[t]o the extent that an allowed secured claim is secured by property the value of which . . . 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 for under the agreement or State statute under which such claim arose."[60] Under section 506(b), therefore, if an oversecured creditor's right to payment under a prepayment clause is characterized as "interest" or as a reasonable "fee" or "charge," that right to payment will be respected.

A. Prepayment Clauses under section 506(b): Case Law

This section summarizes the case law applying section 506(b) to prepayment fees and no calls. It shows that courts have generally treated prepayment fees as "charges" or "fees" subject to scrutiny under the law of liquidated damages. At the same time, courts have generally agreed that no calls are *not* subject to section 506(b); nonetheless, in some cases, they have fashioned remedies to prevent lenders from entirely losing the benefit of their bargain.

1. Prepayment Fees

Courts have consistently held (or simply assumed) that contractual prepayment fees are "fees" or "charges" covered by section 506(b) to the extent they are "reasonable."[61] As a result, courts have *not* treated prepayment fees as "interest," despite the fact that prepayment fees largely serve as a replacement for interest when debts are repaid prior to maturity.

Putting aside this area of consensus, courts have disagreed about practically everything else, including the measure of "reasonableness" under section 506(b). Attempting to make sense of the pertinent case law is not easy. One simple way to organize the cases is to distinguish (a) cases that ultimately require a prepayment fee to approximate the actual damages suffered by lenders as a result of prepayment, and (b) cases that will enforce a prepayment fee in bankruptcy even if

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[59] 11 U.S.C. § 502(b)(1) (2006).

[60] 11 U.S.C. § 506(b) (emphases added).

[61] *E.g.*, Gencarelli v. UPS Capital Bus. Credit, No. 06-2700, 2007 WL 2446883, at * 2 (1st Cir. Aug. 30, 2007) (reasonable prepayment fees are "charges" or "fees" covered by section 506(b)). *See also In re* Imperial Coronado Partners, Ltd., 96 B.R. 997, 1000 (B.A.P. 9th Cir. 1989) (prepayment fees are "charges" subject to section 506(b)).

it may overcompensate the lender.[62] This approach, however, glosses over multiple distinctions within each category of cases as well as similarities between cases that reach different results on the actual damages question.

Here, in order to summarize the cases, we start with what they have in common: For the most part, courts assume that the purpose of a prepayment fee is to liquidate the damages owing in the event of prepayment. Consequently, as demonstrated below, most cases that have applied section 506(b) to prepayment fees have engaged in a state-law liquidated damages analysis.[63] In analyzing prepayment fees, therefore, these cases have considered whether, as one court summarized the standard by which liquidated damages clauses are evaluated at common law, "(1) actual damages may be difficult to determine and (2) the sum stipulated is not 'plainly disproportionate' to the possible loss."[64]

The reason courts have resorted to state liquidated damages law in applying section 506(b) of the Bankruptcy Code varies by case. Some courts have concluded that prepayment fees have to satisfy *both* state and federal law before they can be enforced against a debtor.[65] The rationale for these decisions is straightforward: section 502(b)(1) of the Bankruptcy Code "requires that the validity of claims be determined according to non-bankruptcy law," and section 506(b), rather than overriding that requirement, "creates a supplemental requirement that the charge be reasonable."[66] Other courts, without deciding whether a prepayment fee needs to

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[62] For cases requiring lenders to prove that a prepayment fee approximates actual damages, see, for example, *Coronado Partners*, 96 B.R. at 1001; *In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. 823, 830–31 (Bankr. E.D. La. 2001); *In re Anchor Resolution Corp.*, 221 B.R. 330, 341 (Bankr. D. Del. 1998); *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 425 (Bankr. S.D. Ohio 1993); *In re Duralite Truck Body & Container Corp.*, 153 B.R. 708, 714–15 (Bankr. D. Md. 1993); *In re 433 S. Beverly Drive*, 117 B.R. 563, 569 (Bankr. C.D. Cal. 1990); *In re A.J. Lane & Co.*, 113 B.R. 821, 828–29 (Bankr. D. Mass. 1990); *In re Kroh Bros. Dev. Co.*, 88 B.R. 997, 1001 (Bankr. W.D. Mo. 1988); *In re Skyler Ridge*, 80 B.R. 500, 504–07 (Bankr. C.D. Cal. 1987); and *In re Am. Metals Corp.*, 31 B.R. 229, 237 (Bankr. D. Kan. 1983). For cases under which a prepayment fee does not necessarily have to approximate actual damages, see, for example, *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122, 131–34 (Bankr. E.D.N.Y. 2002); *In re Hidden Lake Ltd. P'ship*, 247 B.R. 722, 729 (Bankr. S.D. Ohio 2000); *In re Lappin Elec. Co.*, 245 B.R. 326, 328–29 (Bankr. E.D. Wis. 2000); *In re Fin. Ctr. Assocs.*, 140 B.R. 829, 835–36 (Bankr. E.D.N.Y. 1992); and *In re Schaumburg Hotel Owner Ltd. P'ship*, 97 B.R. 943, 953–54 (Bankr. N.D. Ill. 1989).

[63] There are exceptions. In *Coronado Partners*, en route to remanding to the bankruptcy court so that lenders could present evidence of actual damages, the Bankruptcy Appellate Panel for the Ninth Circuit stated without further explanation that "[w]hat constitutes a 'reasonable' charge under section 506(b) is a question of federal, not state law." 96 B.R. at 1000–01 (citing *In re* 268 Ltd., 789 F.2d 674, 676–77 (9th Cir. 1986)).

[64] United Merchs. & Mfrs. v. Equitable Life Assurance Soc'y of the U.S. (*In re* United Merchs. & Mfrs., Inc.), 674 F.2d 134, 142 (2d Cir. 1982) (analyzing New York liquidated damages law).

[65] *Skyler Ridge*, 80 B.R. at 503–04; *In re* Morse Tool, Inc., 87 B.R. 745, 748–50 (Bankr. D. Mass. 1988); *Kroh Bros.*, 88 B.R. at 999; (Bankr. D. Mass. 1988); *Lappin*, 245 B.R. at 328–29.

[66] *Morse Tool*, 87 B.R. at 748. The *Morse Tool* decision has an extended discussion of cases that conclude that section 506(b) supplants section 502(b)'s threshold requirement that an allowed claim be valid under state law. The court concluded that those cases rely on unreliable statements by the floor managers of the Bankruptcy Reform Act of 1978 to the effect that attorney's fees could be awarded under the Code "notwithstanding contrary law." The court relied instead on the canon of interpretation under which implied exceptions (in this case, to section 502(b)) are disfavored, as well as on other legislative history stating that section 506(b) was *not* intended to supplant state law. *Id.* at 748–50.

pass muster under state law, have concluded that state law governing liquidated damages should be determinative in evaluating prepayment clauses under section 506(b).[67] Finally, some courts have definitively held that state law is *not* binding under section 506(b), but have still relied on that law as a guidepost in applying section 506(b)'s "reasonableness standard."[68]

While agreeing that state law governing liquidated damages is the logical starting point for analyzing prepayment fees, courts have reached vastly different conclusions as to whether, and in what circumstances, prepayment fees should be enforced under that body of law.

a. In some cases, courts have found that the only type of prepayment fee that is enforceable as a liquidated damages clause is one based on a formula that closely approximates actual damages. In *A.J. Lane*, for example, the bankruptcy court refused to enforce a prepayment charge equal to a fixed percent of the prepayment. The court analyzed the charge using a standard set forth in the Restatement of Contracts: "Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of [1] the *anticipated or actual loss* caused by the breach and [2] the difficulties of proof of loss."[69] The court found that neither of these factors weighed in favor of upholding the prepayment charge. *First*, in the court's view, the charge approximated neither the damages anticipated at the time the loans were extended nor the actual damages suffered by the lenders—in the first case because, while interest rates could have risen or fallen, the charge "presumes that damages will be sustained," and in the second case because interest rates had actually risen since the loans were extended, meaning that that the lenders "benefited from the prepayment."[70] *Second*, the court found that the lenders' lost yield would *not* be difficult to prove at the time of the breach: "The damage formula is simple and well established. It is the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected

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[67] *E.g.*, *Fin. Ctr. Assocs.*, 140 B.R. at 838. The *Financial Center Associates* court noted that the legislative history supporting a pure federal standard referred to attorneys' fees only, which bankruptcy courts have experience in assessing. On the other hand, since "there is no uniform federal standard that can assist [courts] in determining the reasonableness of [a] prepayment charge," it makes sense to rely on "a proper, developed and familiar set of standards" supplied by state law. *Id*. at 839.

[68] In *A.J. Lane*, the court concluded, based in part on the legislative history rejected in *Morse Tool*, that federal courts operate on a "slate which is clear of binding state court precedent" in evaluating prepayment charges. 113 B.R. 821, 824–25 (Bankr. D. Mass. 1990). Nonetheless, the court looked to state law for "guidance" in dealing with prepayment charges. *Id*. at 825.

[69] *Id*. at 830 (quoting Restatement (Second) of Contracts § 356(1) (emphasis added)). *See* U.C.C. § 2-718(1) (similar statement of rule). This statement of the rule is different from the "traditional" rule because it permits enforcement of a liquidated damages amount that is commensurate with the actual loss caused by a breach but not commensurate with the anticipated harm at the time of contracting. *See A.J. Lane*, 113 B.R. at 828; *see also* 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.18, at 310 (3d ed. 2004) (under the Restatement approach, "a court should look to the actual loss to sustain provisions that might otherwise be unenforceable, but not to strike down provisions that would otherwise be enforceable").

[70] *A.J. Lane*, 113 B.R. at 829.

over the term of the loan and then discounted to arrive at present value."[71] The court thus disallowed the fixed prepayment charge in its entirety.

In other cases, courts have likewise found prepayment charges to be unreasonable as a matter of state law because they varied from a close measure of actual damages. In both *Skyler Ridge* and *Kroh Brothers*, for example, bankruptcy courts examined prepayment clauses that fixed damages by multiplying the amount of the prepayment, the number of years remaining on the loan, and the difference between the interest rate on the loan and current yield on U.S. Treasury notes with the same maturity as the loans.[72] In both cases, the courts found that these formulas could not be enforced, because they were not reasonable forecasts of the damages to be caused by prepayment. According to the cases, the formula had two flaws: (i) it set the "market rate of interest," *i.e.*, the rate at which the lenders could reinvest, at the yield for Treasury notes rather than the higher yield for mortgages, and (ii) it failed to discount lost yield to present value.[73] These cases, therefore, assume that a lender will be able to redeploy prepaid funds immediately upon prepayment and with minimal transaction costs.[74]

Since the *A.J. Lane*, *Skyler Ridge*, and *Kroh Brothers* courts all concluded that the clauses at issue improperly failed to approximate actual damages, as required by nonbankruptcy law, they had limited occasion to apply section 506(b)'s "reasonableness" standard. The *Kroh Brothers* court found that the charge at issue was unreasonable under section 506(b) "for reasons set forth above" *and* because section 506(b), independent of state law, provides only for actual costs, charges and fees.[75] *Skyler Ridge* noted simply that the charges at issue were "unreasonable under section 506(b), for the same reasons that they are unreasonable under Kansas law."[76] In *A.J. Lane*, finally, because the court borrowed entirely from common law

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[71] *Id*. (citing Teachers Ins. & Annuity Ass'n of Am. v. Butler, 626 F. Supp. 1229, 1236 (S.D.N.Y. 1986)).

[72] *In re* Kroh Bros. Dev. Co., 88 B.R. 997, 1000 (Bankr. W.D. Mo. 1988); *In re* Skyler Ridge, 80 B.R. 500, 502, 505 (Bankr. C.D. Cal. 1987).

[73] *Kroh Bros*., 88 B.R. at 1000–01; *Skyler Ridge*, 80 B.R. at 505.

[74] Relying on *Skyler Ridge* and *Kroh Brothers*, a district court in the Northern District of Illinois likewise held that a prepayment clause that used a treasury-based reinvestment rate did not pass muster under Illinois liquidated damages law. *See* River East Plaza, L.L.C. v. Variable Annuity Life Co., No. 03 C 4354, 2006 WL 2787483, at *10 (N.D. Ill. Sept. 22, 2006). On appeal, the Seventh Circuit reversed the district court's decision; in doing so, the court concluded that the treasury-based formula was *not* a penalty, because the purpose of the clause was to serve as an "alternative performance" option rather to compel performance from the borrower under the original contract. *River East*, No. 06-3856, 2007 WL 2377383, at *5 (7th Cir. Aug. 22, 2007). According to the court, even though the lender might end up benefiting from prepayment by reinvesting in a comparable credit, the borrower benefited from prepayment by shedding the obligation to pay most of the interest remaining on the loan. *Id*. Later in the opinion, the court went on to suggest that, even if the YMF at issue were viewed as a liquidated damages clause, it would be enforceable given the various risks and uncertainties attendant to reinvestment. *See id*. at *6–7. For a further discussion of whether prepayment fees are properly viewed as alternative performance clauses rather than liquidated damages clause, see *infra* Part III.B.1.

[75] *Kroh Bros*., 88 B.R. at 1001.

[76] *Skyler Ridge*, 80 B.R. at 507. The only difference identified by the *Skyler Ridge* court between state law and section 506(b) is that, while Kansas law required disallowance of the *entire* charge at issue, section 506(b) may permit the reasonable portion of a fee to be enforced. *Id*. On the other hand, *Kroh Brothers*

to fill in section 506(b)'s "reasonableness" standard, the court concluded its analysis when it determined that the fixed charge at issue was unenforceable under nonbankruptcy law.

b. In a second body of cases, most of which have arisen in the Second Circuit, courts have sustained prepayment fees as valid liquidated damages clauses regardless of whether they are based on a formula that approximates actual damages. At the same time, however, some of those courts have also concluded that federal bankruptcy law is more exacting than state liquidated damages law.

The Second Circuit's decision *In re United Merchants and Manufacturers, Inc*.[77] is a leading case supporting the enforcement of prepayment fees under a liquidated damages analysis. That case, which arose under the Bankruptcy Act of 1898, involved an unsecured loan evidenced by an agreement that included a liquidated damages provision under which, in the event of default and acceleration, the borrower had to pay a sum equal to the amount that would be payable in the event of a prepayment.[78] The Second Circuit held that, as a matter of New York law, the prepayment fee provision in the loan agreement was an appropriate liquidated damages clause. The court found that (i) damages resulting from prepayment of a large loan are difficult to determine in advance and (ii) the amount stipulated in the loan agreement was not "plainly disproportionate" to the lenders' possible loss.[79] In concluding that damages are difficult to estimate, the court relied on its earlier decision in *Walter E. Heller & Co. v. American Flyers Airlines Corp*.,[80] which had identified multiple variables that make a lender's losses difficult to pin down: "rate of return, duration of the loan, risk, extent and realizability of collateral, and the other obvious uncertainties inherent in this particular contract [that] combined to make it difficult to foresee, at the time the contract was executed, the extent of damages which might arise from the breach of the loan agreement."[81]

Applying the liquidated damages approach set forth in *United Merchants*, the bankruptcy court in *In re Financial Center Associates* approved a prepayment fee under section 506(b) that amounted to approximately 25% of the $26.75 million loan at issue.[82] The debtor claimed that this fee was unreasonable because the formula chosen by the parties used a discount rate based on the yield for United States Treasury Bonds rather than for real property mortgages, the result of which was a fee that was not commensurate with actual damages. In rejecting the debtor's position—precisely the one accepted in *Skyler Ridge* and *Kroh Brothers*—the court

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found that the charge at issue could be sustained under Missouri law to the extent of damages actually incurred. *Kroh Bros*., 88 B.R. at 999.

[77] 674 F.2d 134 (2d Cir. 1982).

[78] *Id*. at 140–42 & n.7. The prepayment fee at issue was based on a formula that is omitted from the Second Circuit's decision.

[79] *Id.* at 142–43.

[80] 459 F.2d 896 (2d Cir. 1972).

[81] *In re United Merchs.*, 674 F.2d at 143 (quoting *Heller*, 459 F.2d at 900).

[82] *In re* Fin. Ctr. Assocs., 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992).

concluded first that prepayment damages are not easily ascertainable, because "many unknown factors" go into quantifying them, including:

> the loss upon pre-payment of all of the interest to which the lender is entitled; the cost and expenses of procuring a substitute borrower and the attendant risk and delay involved; the applicable rate of return; the duration of the loan and the risk involved in each specific transaction; the extent and realizability of the collateral; and "other obvious uncertainties inherent in this particular contract."[83]

According to the court, therefore, even if the general formula for calculating damages is relatively simple,[84] applying that formula at the time of breach is "far from simple," because the court needs to determine, *inter alia*, what reinvestment rate to compare to the interest rate on the loans.[85] Next, the court determined that the sum resulting from the treasury-based formula was not "plainly disproportionate" to the lenders' potential damages, both because hindsight cannot be used to determine reasonableness and because "the contract provides for a formula to be used in computing the charge, not for a fixed sum."[86] On those bases, the court upheld the makewhole at issue as a valid liquidated damages clause.[87]

While *Financial Center Associates* involved a formula rather than a fixed charge, at least one case under the Bankruptcy Code has concluded that a fixed charge is likewise sustainable under section 506(b) as a liquidated damages clause. In *In re Schaumburg Hotel Owner Ltd. Partnership*,[88] the bankruptcy court approved a prepayment fee set at 10% of the outstanding principal amount of a loan.[89] In doing so, the court embraced the arguments adopted in *Financial Center Associates*, including (a) that the reasonableness of liquidated damages estimates should not be evaluated based on hindsight (in other words, the difference between

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[83] *Id.* at 836 (quoting *In re United Merchs.*, 674 F.2d at 143–44).

[84] It is "the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected over the term of the loan and then discounted to arrive at present value." *Id.* (quoting *A.J. Lane*, 113 B.R. at 829).

[85] *Id.* at 837.

[86] *Id.*

[87] *Accord In re* CP Holdings, Inc., 332 B.R. 380, 389–92 (W.D. Mo. 2005) (sustaining treasury-based YMF under Missouri law and section 506(b)) (emphasizing sophistication of parties, market practice of using treasury benchmarks, and difficulty in predicting losses incurred upon reinvestment), *aff'd*, 206 Fed. App'x. 629 (8th Cir. 2006) (unpublished); *In re* Vanderveer Estates Holdings, Inc., 283 B.R. 122, 132 (Bankr. E.D.N.Y. 2002) (sustaining treasury-based YMF under New York law and section 506(b) and rejecting the "presum[ption] that the lender will be able immediately to invest the prepaid monies in a loan of comparable risk, size and maturity"); *In re* Hidden Lake Ltd., 247 B.R. 722, 727–29 (Bankr. S.D. Ohio 2000) (sustaining treasury-based YMF as valid liquidated damages clause under Ohio law).

[88] 97 B.R. 943 (Bankr. N.D. Ill. 1989).

[89] *Id.* at 953–54.

actual damages and agreed-upon damages is beside the point),[90] and (b) that the damages resulting from prepayment are difficult to establish.[91]

Because *United Merchants* and its progeny have concluded that prepayment fees may be sustained under state law even if they may overcompensate a creditor, those cases have had to determine whether section 506(b) imposes an additional "reasonableness" requirement above and beyond state law. They have reached somewhat different conclusions on this question. In *United Merchants* itself (which did not involve section 506(b)), the Second Circuit left open the possibility that a court could exercise its discretion under the Bankruptcy Act to invalidate a valid prepayment clause under New York law—*if* the debtor could prove that no actual damages were suffered by the lender.[92] That approach would differ from one under which lenders must prove actual damages only in the sense that the debtor would bear the burden of disproving damages rather than the other way around.

Cases applying section 506(b) of the Bankruptcy Code have taken a narrower view of the bankruptcy court's power. In *Financial Center Associates*, the court stated, that "[a]t best we are willing to view the 'reasonable' standard of § 506(b) in the context of pre-payment clauses as a safety valve which must be used cautiously and sparingly as all discretionary powers that are not subject to close scrutiny and statutory standard."[93] Although the court noted that there may be charges that survive state-law scrutiny but are "so large and so unjust to the estate and its creditors" that they should be disallowed under section 506(b), the court concluded that the 25% charge at issue did not fall in that category.[94]

2. No Calls

There are fewer cases applying section 506(b) of the Bankruptcy Code to no calls than cases applying that provision to prepayment fees. With one exception, the cases that do apply section 506(b) to no calls agree on one thing: A contractual prohibition on prepayment should not be specifically enforced in bankruptcy to

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[90] *Id*. at 953 ("It is immaterial that the actual damages suffered are higher or lower than the amount specified in the clause." (citing *In re United Merchs.*, 674 F.2d at 142)). Notably, the lender in *Shaumburg* submitted proof showing that its actual prepayment damages were almost $1 million greater than the 10% contractual pre-payment fee (*id.* at 954); thus, it is not clear that the court would have upheld the fee if the actual damages to the lender were below 10%.

[91] *Id*.

[92] United Merchs. & Mfrs. v. Equitable Life Assurance Soc'y of the U.S. (*In re* United Merchs. & Mfrs., Inc.), 674 F.2d 134, 143 (2d Cir. 1982).

[93] 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992); *accord Vanderveer*, 283 B.R. at 133.

[94] *Fin. Ctr. Assocs.*, 140 B.R. at 839. At least one court has perceived a sharper distinction between state law and section 506(b). In *Duralite*, the bankruptcy court agreed with the *Financial Center Associates* court that New York law does not require a prepayment fee to approximate actual damages. However, the court concluded that under section 506(b), prepayment clauses *do* have to approximate actual damages. *In re* Duralite Truck & Body Container Corp., 153 B.R. 708, 713–14 (Bankr. D. Md. 1993). The court thus rejected a formula that "presume[d] a loss"; according to the court, the fact that the parties had negotiated a floating rate loan, along with the fact that the lender could have reinvested at a similar rate, meant that the prepayment charge at issue was not "reasonable." *Id.* at 715.

prevent prepayment.[95] Given that the breach of a no call is not likely to be remedied outside of bankruptcy through a decree of specific performance,[96] this consensus is neither surprising nor informative.

The real issue is whether, when a debtor prepays a loan in the face of no call, the damages resulting from such prepayment should be allowed under the Bankruptcy Code. In cases involving oversecured creditors, courts have taken two approaches. In one group of cases, courts have held that, because a *prohibition* on prepayment (as opposed to a prepayment fee) is not a "charge[] provided for under the agreement" for purposes of section 506(b), damages resulting from violation of that prohibition are *not* part of a secured claim.[97] These cases adopt the view that, while section 506(b) will protect a lender that liquidates the damages resulting from prepayment, a lender that does not insist upon a prepayment fee is not entitled to a secured claim for prepayment damages,[98] although it may be entitled to an unsecured claim for those amounts.[99]

In a second group of cases involving oversecured creditors, courts have likewise declined to include the measure of damages resulting from breach of a no call in the lender's secured claim. However, rather than providing no relief under

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[95] *E.g.*, Cont'l Sec. Corp. v. Shenandoah Nursing Home P'ship, 193 B.R. 769, 774 (W.D. Va. 1996) (affirming bankruptcy court decision that no call was "not enforceable in this [Chapter 11] context"), *aff'd* 104 F.3d 359 (4th Cir. 1996); *In re* Vest Assocs., 217 B.R. 696, 699 (Bankr. S.D.N.Y. 1998) (noting the absence of any dispute that prepayment could take place notwithstanding a contractual no call); *In re* Skyler Ridge, 80 B.R. 500, 502 (Bankr. C.D. Cal. 1987) (prohibition on prepayment "not enforceable in a bankruptcy case"); *In re* 360 Inns, Ltd., 76 B.R. 573, 575–76 (Bankr. N.D. Tex. 1987) (authorizing repayment of a note despite no call); *see also In re* Calpine Corp., 365 B.R. 585, 597 (S.D.N.Y. 2007) (permitting repayment of outstanding principal notwithstanding no call; repayment "stopped the unnecessary loss of funds from Debtors' estates"). In one outlier case, a bankruptcy court refused to allow a debtor to repay a debt subject to a no call. *See In re* Premier Entm't Biloxi LLC, No. 06-50975 (Bankr. S.D. Miss. Feb. 2, 2007) [Docket No. 300]. The court offered no explanation as to why specific performance, as opposed to damages, was an appropriate remedy for the debtor's proposed breach. *See id*.

[96] *See* Teachers Ins. & Annuity Ass'n of Am. v. Ormesa Geothermal, 791 F. Supp. 401, 415–16 (S.D.N.Y. 1991) (damages for breach of no call measured by determining discounted present value of incremental interest income lost as result of breach).

[97] *Vest Assocs.*, 217 B.R. at 699; *Shenandoah Nursing*, 193 B.R. at 774. Notably, these cases do not consider the effect of a broad indemnity clause under which a borrower must indemnify its lenders for all amounts owing in respect of a loan agreement. If included in a loan agreement, such a clause would arguably mean that all damages for breach of the agreement would be "provided for under the agreement" for purposes of section 506(b).

[98] *Vest Assocs.*, 217 B.R. at 699–700 (bankruptcy court cannot "read into a contract damage provisions which the parties themselves have failed to insert regarding the liquidation or calculation of damages arising out of the prepayment of a loan"); *Shenandoah Nursing*, 193 B.R. at 774 ("While there is a prepayment prohibition, which is not enforceable in this context, there is no prepayment penalty provision provided for anywhere in the contract. Therefore, there can be no prepayment fees, costs, or charges allowed under the confirmed Plan as none are provided for in the note under § 506(b)."); *cf. In re* Adelphia Commc's Corp., 342 B.R. 142, 153 (Bankr. S.D.N.Y. 2006) (oversecured creditors not entitled to charge a higher interest rate as a result of the debtor's misrepresentations in compliance certificates where credit agreement did not specifically provide for such an adjustment as a remedy (citing *Shenandoah Nursing*, 193 B.R. at 774–75)).

[99] In *Calpine*, the bankruptcy court agreed that section 506(b) has no application to a no call, but found that lenders were entitled to an unsecured claim for damages resulting for breach of the no call. *See Calpine*, 365 B.R. at 399–400. See *infra* Part IV for a further discussion of unsecured claims based on prepayment clauses.

section 506(b), courts have searched the parties' agreement for a prepayment fee that would survive under section 506(b), and have effectively substituted that fee for an unenforceable no call. In *Skyler Ridge*, for example, the loan agreement at issue prohibited prepayment for two years, during which time the debtor filed for bankruptcy protection and proposed to repay its debt. Despite the fact that the contract's prepayment fee clause was not yet applicable, the court looked to the fee imposed by that clause and concluded that, if it were "reasonable," it would be the basis for a secured claim under section 506(b).[100] Similarly, in *In re 360 Inns, Ltd.*,[101] the loan agreement forbade voluntary prepayments during the first ten years of its term; nonetheless, the court looked to the prepayment fee applicable to *in*voluntary payments, and concluded that the debtor's plan could only be confirmed if it proposed to pay that fee to the lenders in the event of a prepayment during the no call period.

In sum, the cases consistently hold, without extensive analysis, that the full measure of damages for breach of a no call are not covered by section 506(b). The cases part ways, however, with respect to whether a court should essentially craft a replacement prepayment fee that survives scrutiny under section 506(b). Notably, in holding that section 506(b) does not protect damages for breach of a no call, courts apparently have not been troubled by the fact that, according to their interpretation of section 506(b), the Bankruptcy Code respects liquidated damages clauses (makewholes) aimed at quantifying prepayment damages but offers no secured claim for such damages themselves, even if they are readily quantifiable under state law.

B. Prepayment Clauses under section 506(b): Analysis of Case Law

The cases summarized above, nearly all of which examine prepayment clauses through the lens of state liquidated damages law, share common premises: *First*, they assume that a prepayment clause is properly treated as a liquidated damages clause because it is a provision "inserted [in a loan agreement] to compensate the lender for the *breach* of early payment."[102] *Second*, they assume that any payment obligation resulting from a prepayment clause is necessarily a "charge" or a "fee" under section 506(b), and therefore has to be "reasonable" and "provided for under the [loan] agreement."

Each of these premises requires scrutiny. It is not self-evident that *all* prepayment fees, including those that make no attempt to approximate the actual damages resulting from prepayment, should be treated as liquidated damages clauses as opposed to alternative performance clauses. It also is not self-evident that the payment obligations arising out of prepayment clauses are *all* "charges" or

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[100] *Skyler Ridge*, 80 B.R. at 504–07.

[101] 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987).

[102] *In re* A.J. Lane & Co., Inc., 113 B.R. 821, 827 (Bankr. D. Mass 1990) ("The prepayment charge . . . is a natural result of treating prepayment as a breach, and the charge should be considered in that light.").

"fees," even though the evident purpose of some of these provisions (YMFs and no calls) is to calculate the value of a stream of interest payments. Here, we conclude (a) that fixed-fee prepayment clauses are better characterized as alternative performance clauses than liquidated damages clauses, and (b) that the obligations arising out of no calls and yield maintenance formulas are better characterized as "interest" than as "charges" or "fees."

1. Alternative Performance versus Liquidated Damages Clauses

At common law, "[a] contract may give an option to one or both parties to either perform a specified act or make a payment."[103] Although such an option cannot be used "as a cover for the enforcement of a penalty," if "at the time fixed for performance, either alternative might prove the more desirable, the contract will be enforced according to its terms."[104] In determining whether an apparent option is really a disguised penalty clause, "[a] chief factor in resolving the question is whether the promisor has free choice between performances."[105] Other factors, which are consistent with the notion that each alternative has to be clearly preferable in some real-world circumstances, "include whether the promisor had a 'true option' on which alternative to perform, whether the money payment is equivalent to performance of the option, and the relative values of the performances" [*i.e.*, whether one "option" will always have a higher value to the counter-party than the other, as with a penalty].[106]

Outside of bankruptcy, prepayment fees have regularly been treated as alternative performance clauses.[107] Indeed, the Seventh Circuit recently embraced this approach, concluding that, under Illinois law, a prepayment fee (in particular, a YMF) was enforceable against a borrower as an alternative performance (as

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[103] 14 RICHARD A. LORD, WILLISTON ON CONTRACTS § 42:10, (4th ed. 2000).

[104] *Id*.

[105] *Id*. (quoting from Bellevue Sch. Dist. No. 405 v. Bentley, 684 P.2d 793 (Wash. Ct. App. 1984). *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. c ("A court will look to the substance of the agreement to determine whether . . . the parties have attempted to disguise a provision for a penalty that is unenforceable . . . . In determining whether a contract is one for alternative performances, the relative value of the alternatives may be decisive.").

[106] 14 RICHARD A. LORD, WILLISTON ON CONTRACTS § 42:10, (4th ed. 2000) (quoting from Bellevue School Dist. No. 405 v. Bentley, 684 P.2d 793 (Wash. App. 1984)). *See* 11 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 58.18, at 509 (2006) ("Interpretation depends on the expressions of the parties, but those expressions are given legal effect only when understood in the company they keep. If for a single consideration, a person promises to pay $100 by May 1, or $500 thereafter, and states that the contract is to be interpreted as in the alternative, a court would refuse to accept the indicated interpretation.").

[107] PERILLO, *supra* note 106, § 58.18, at 505 & n.5 (citing, *e.g.*, Atl. Ltd. P'ship-XI v. John Hancock Mut. Life Ins. Co., 95 F. Supp. 2d 678, 683–84 (E.D. Mich. 2000); *see, e.g.*, Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006) ("When a prepayment clause is included as part of the loan obligation, it is generally analyzed as an 'option' for alternative performance on the loan, and any premium is deemed consideration or a quid pro quo for the option."); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Assn., 22 Cal. App. 3d 303, 304 (1st Dist. 1971). For additional citations to state cases treating prepayment clauses as options, see John C. Murray, *Prepayment Premiums: A Bankruptcy Court Analysis of Reasonableness and Liquidated Damages*, 105 COM. L. J. 217, 229 & n.33 (2000).

opposed to a liquidated damages) clause.[108] The court viewed the prepayment fee at issue as a *bona fide* option because, by paying the fee, the borrower was able to escape future interest payments that exceeded the fee.[109]

Where a prepayment fee is fixed at an amount that could be easily eclipsed by the savings upon refinancing (*e.g.*, 2% of the prepaid amount), the conclusion that the fee should be treated as an alternative performance clause is easily supportable. In that circumstance, there is no doubt that the borrower "has free choice between performances" (*i.e.*, paying early or adhering to the original schedule) and has a "true option" between alternatives that could each be preferable in certain circumstances. Moreover, by agreeing to such a fixed fee, it is apparent that, rather than trying to simplify an otherwise complicated damages calculation, the loan parties have decided instead to share the risk of a decline in the interest rates available to the borrower. A fixed prepayment fee is not an estimate of the interest that would otherwise be payable in exchange for the use of borrowed funds; rather, it is a charge to the borrower "for the privilege of repaying the loan before maturity."[110]

YMFs are different. Where loan parties use a formula to fix the lender's projected reinvestment, their goal is not to allocate risk but rather to simplify the judicial process that follows from breach. The borrower's "option" in that circumstance is similar to any contract party's "option" to breach when the cost of such breach is surpassed by its benefits. The purpose of using a formula is to liquidate damages, and the decision to pay such damages does not result from exercise of a "true option" between different modes of *performance* but rather from the unusual circumstances that make a *breach* efficient (*i.e.*, the benefits to a borrower from prepayment exceed the lender's damages). For that reason, the Seventh Circuit's decision in *River East*, which treated a YMF as an alternative performance clause, is not entirely convincing. The Seventh Circuit's decision is predicated on the notion that, unlike a "penalty," a YMF does not necessarily deter prepayment, because it allows the borrower to avoid future interest payments by paying a fee equal to a small fraction of those payments (indeed, an amount significantly lower than their present value).[111] The same point, however, could be

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[108] *See* River East Plaza v. The Variable Annuity Life Ins. Co., No. 06–3856, 2007 WL 2377383, at *5–6 (7th Cir. Aug. 22, 2007).

[109] *Id*. The court also suggested that the YMF could be enforced under liquidated damages law. As in cases such as *Financial Center Associates* and *Vanderveer*, the court noted that there are numerous factors that determine the lenders' yield upon reinvestment, including "potential fluctuations of interest rates, regulatory pressures faced by insurers like [the lender], long-term risk of depressed real estate markets, availability of suitable replacement property owners, and any of a myriad other factors." *Id.* at *7. Given this analysis, along with language in the opinion suggesting that liquidated damages law might be used as an "analogy" in evaluating prepayment clauses, *id*. at *6, the decision does not squarely support the conclusion that YMFs or other prepayment clauses should never be analyzed as liquidated damages clauses.

[110] Boyd v. Life Ins. Co., 546 S.W.2d 132, 133 (Tex. Civ. App. 1977).

[111] *River East*, 2007 WL 2377383, at *4 ("By electing an option to pay early, [the borrower] avoided paying the $13 million in remaining interest payments that would have been due between 2003 and 2020, and instead paid only $3.9 million.").

made about a no call, which clearly is not an "alternative performance" clause. Unless breach of a no call leads to some harm besides damages (for example, a cross-default), such a breach puts the borrower in the same position as a YMF—*i.e.*, it allows the borrower to pay current damages (if there are any) rather than future interest. The Seventh Circuit's analysis, therefore, is persuasive insofar as it rejects the notion that prepayment fees are necessarily liquidated damages clauses; it is less persuasive, however, insofar as it distinguishes between a YMF in particular from a liquidated damages clause. Unlike a fixed prepayment fee, which presents the borrower with a "true option" other than breach, the "option" presented by a YMF is in substance no different from a breach.

Notwithstanding the apparent distinction between (a) prepayment fee clauses that function as alternative performance options and (b) those that function like liquidated damages clauses, bankruptcy courts have generally treated *all* prepayment fee clauses as liquidated damages clauses. While most courts have done so without comment, the *A.J. Lane* court specifically addressed and dismissed the suggestion that a prepayment fee should be viewed as an "alternative contract." It did so on two grounds: *First*, the court noted that "the courts of this country and England have regarded prepayment as a breach of contract";[112] "[u]nder a true alternative contract," however, "performance does not, of itself, constitute a breach of the alternative promise."[113] In other words, since a prepayment is necessarily a breach, it cannot be an alternative method of performance. *Second*, the court contended that, while an alternative contract is one in which "either alternative is equally open to the promisor,"[114] prepayment is *not* equally open to the borrower as payment over time; "if it were, the Debtor would not have borrowed the money."[115]

The strength of *A.J. Lane*'s first contention—namely, that prepayment is necessarily a breach of contract—depends in the first instance on the vitality of the perfect tender in time rule. While that rule remains the law in some states, including New York,[116] it has been rejected in others.[117] Even in jurisdictions that accept the perfect tender rule, however, *A.J. Lane*'s reliance on that rule as a basis to treat any prepayment fee as a liquidated damages clause is questionable. In *Carlyle Apartments Joint Venture* v. *AIG Life Insurance Co.*,[118] the Court of Appeals of Maryland construed a prepayment clause in a commercial loan agreement as

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[112] *In re* A.J. Lane Co., Inc., 113 B.R. 821, 827 (Bankr. D. Mass. 1990) (citing Abbe v. Goodwin, 7 Conn. 377 (1829) and Brown v. Cole, 14 L.J. Ch. 167 (1845)).

[113] *Id*.

[114] *Id.*

[115] *Id*.

[116] *See* Nw. Mut. Life Ins. Co. v. Uniondale Realty, 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006) (citing Arthur v. Burkich, 131 A.D.2d 106, 107 (N.Y. App. Div. 1987)) ("Under the perfect tender in time rule a mortgagor has no right to prepay a note prior to its maturity date 'in the absence of a prepayment clause in the mortgage or contrary statutory authority' and such rule 'has been settled law since the early 19th century.'").

[117] *E.g.*, Hatcher v. Rose, 407 S.E.2d 172, 177 (N.C. 1991); Skyles v. Burge, 789 S.W.2d 116, 119 (Mo. Ct. App. 1990); Mahoney v. Furches, 468 A.2d 458 (Pa. 1983).

[118] 635 A.2d 366 (Md. 1994).

offering the borrower an alternative method of performance rather than an amount of damages to be paid in the event of breach.[119] Although recognizing that Maryland law creates a default rule under which a borrower does not have the right to prepay, the court found that, where the parties opt out of that default rule by agreeing to a prepayment fee, prepayment is not a "breach" that would justify a resort to the law of liquidated damages.[120] The court dismissed the suggestion that a prepayment *permitted by contract* is a breach as "Orwellian," concluding instead that such prepayment is "contract-conforming" because the parties have opted out of the common law rule under which prepayment would be a breach.[121] The court's basic point is hard to contest: If a loan agreement contains a provision permitting prepayment on certain terms, *neither* of the alternative performances contemplated by the contract is a breach. And if the prepayment charge at issue is a true option, the right to payment that it generates is not a "damages" amount.[122]

The Maryland court also addressed and rejected *A.J. Lane*'s second argument—that prepayment is not an option because it is not "equally open" to the borrower upon entry into a loan agreement. The court concluded that, even if "the possibility of the borrower's actually exercising the option [to prepay] may seem remote at the time the loan is made," once a borrower "voluntarily prepa[ys]" its debts notwithstanding a prepayment fee, prepayment has clearly become the "more desirable" of the alternative performance options under the loan agreement.[123] This argument too is hard to contest: Regardless of whether prepayment is undesirable at the time of entry into a loan (which is itself questionable given that a borrower would presumably prepay a loan with the proceeds of a new loan with slightly better terms), prepayment becomes a "true option" once the expected benefits from prepayment are greater than the prepayment charge. In cases in which a prepayment charge is fixed and interest rates available to the borrower have declined by more than that fixed amount, it is again hard to conceive of the right to payment created by the prepayment clause as a "damages" amount.

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[119] Like *River East*, *Carlyle Apartments* itself involved a yield maintenance formula tied to treasury rates. *See Carlyle Apartments*, 635 A.2d at 366–67. The court did not consider whether such a formula is meaningfully different from a fixed fee.

[120] *Id.* at 368 (citing West Raleigh Group v. Mass. Mut. Life Ins. Co., 809 F. Supp. 384, 391 (E.D.N.C. 1992) (rejecting premise that prepayment provision was liquidated damages clause because it "ignore[d] the fact that there has been no breach of contract in this case; rather, [the borrower] is attempting to voluntarily invoke a contract term—the privilege and option of prepayment"); *see* River East Plaza v. The Variable Annuity Life Ins. Co., No. 06-3856, 2007 WL 2377383, at *5 (7th Cir. Aug. 22, 2007) ("Certainly under any ordinary view of the contract's unambiguous terms, the prepayment is not a breach: the parties explicitly provided that River East would be allowed to prepay.").

[121] *Carlyle Apartments*, 635 A.2d at 369–70 (specifically addressing *A.J. Lane*).

[122] The New York Supreme Court in the *Northwestern* case also treated a prepayment clause as an option; like the Maryland court, the *Northwestern* court reasoned that "such a premium is not enforced as liquidated damages because there has been no breach of the loan agreement, merely alternative performance which is intended to preserve the lender's income stream or yield." Nw. Mut. Life Ins. Co. v. Uniondale Realty, 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006). Unlike the Maryland court, however, the New York court did not analyze the issue further.

[123] *Carlyle Apartments*, 635 A.2d at 371–72.

Finally, the Maryland court brushed aside Professor Dale Whitman's argument that, in the prepayment clause context, the difference between a clause providing for liquidated damages and an alternative performance clause is "entirely illusory."[124] The bases for this argument, as stated by Whitman, are that (i) "it is payment on time, rather than early payment with a fee, that the lender primarily desires and for which the lender bargains" and (ii) "prepayment may cause the lender substantial damage, and the fee's obvious purpose is to compensate for that damage."[125] For Whitman, therefore, all prepayment fees are in substance no different from liquidated damages.

The shortcoming of Whitman's analysis is that, like the Seventh Circuit in *River East* (although with opposite results), Whitman groups all prepayment clauses together. Whitman is probably correct that lenders have bargained for payment on time and full expectancy damages when a prepayment clause, by estimating actual damages, effectively deters refinancing. But when a lender has given up the right to collect full expectancy damages, and has instead agreed that prepayment damages will be capped at a certain percent of a loan, the suggestion that the parties have agreed to a liquidated damages clause is unconvincing. That suggestion is likewise questionable when the loan parties have agreed, for example, that the borrower's debts may be repaid in the event of an asset sale. In sum, the contention that prepayment clauses necessarily function to protect a stream of payments through the term of a loan does not comport with commercial practice.

Treating fixed prepayment fees as options avoids the need to apply the law of liquidated damages to such fees—an exercise that does not yield sound results. Under the Restatement of Contracts, "[d]amages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."[126] There is some confusion in the case law as to whether the difficulty in estimating damages is evaluated only as of entry into the contract or if the difficulty

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[124] *See Carlyle Apartments*, 635 A.2d at 373 (analyzing Whitman, *supra* note 1, at 888). In *River East*, the Seventh Circuit likewise invoked Whitman's article, but downplayed his argument that prepayment clauses are in substance no different from liquidated damages clauses. The court of appeals focused instead on language in Whitman's article suggesting that states have made a mess of liquidated damages law, concluding based on that language that prepayment fees are better analyzed as alternative performance clauses. *See also River East Plaza*, 2007 WL 2377383, at *6.

[125] Whitman, *supra* note 1, at 890. The Maryland court rejected Whitman's analysis on the basis that it "treats an economic objective as a covenant, a failure to reach that objective as a breach of contract, and the shortfall from that objective as damages for breach of contract"; in other words, Whitman does not separate the economic purpose of prepayment clauses from their formal legal status. *Carlyle Apartments*, 635 A.2d at 372. Here, the court appears to dismiss Whitman's position too quickly. Whitman's point is that the legal status of prepayment clauses should be linked to their economic purpose of protecting yield; to reject Whitman's position because he treats prepayment as a breach is to restate rather than respond to his argument.

[126] RESTATEMENT (SECOND) OF CONTRACTS § 356(1). *See* U.C.C. § 2-718(1) (2007).

of measuring damages post-breach is also considered.[127] The cases that have analyzed prepayment clauses, however, are fairly consistent on this subject: They focus on whether, as of entry into the agreement, the parties could reasonably expect to be able to determine the lenders' losses from prepayment *at the time of breach*.[128] While some cases, such as *United Merchants*, hold that lost yield cannot be easily calculated at the time of breach, cases such as *A.J. Lane* conclude that loan parties can calculate their losses based on a straightforward formula. Few of these cases, however, take the view that the mere impossibility of predicting, upon entry into the loan agreement, whether interest rates will rise or decline means that prepayment damages may be fixed at a sum that bears no relation to the lenders' actual loss.[129]

Since courts focus on whether damages are calculable *after* a breach, they may tolerate the use of liquidated damages clauses that simplify the accepted damages formula (*if* they believe that damages under that formula are not easily calculable). However, courts are less likely to tolerate a fixed prepayment fee that fixes an arbitrary damages amount. Indeed, even the courts that have found the formula for determining prepayment damages difficult to apply have indicated that a simplified formula is preferable to a fixed fee that "presumes a loss."[130] Treating a fixed prepayment fee as an *option* avoids the unsupportable result under which a fixed fee that is agreed to by the parties and below the lenders' actual damages might be disallowed because it does not meet the requirements of a liquidated damages clause.

2. "Charges" versus "Interest"

Whether a particular prepayment clause is treated as a liquidated damages clause or an option does not dispose of whether the borrower's payment obligation under such a clause is treated as a "charge" or "fee" or, alternatively, as "interest." The distinction between a "charge" or "fee," on the one hand, and "interest," on the

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[127] The relevant decisions are inconsistent, "sometimes upholding clauses on this point if the harm was difficult to predict when the contract was negotiated, and in other cases scrutinizing the difficulty of measuring damages at the time of the breach." Whitman, *supra* note 1, at 887 (citing various cases).

[128] In a different context, Judge Posner cogently summarized these cases' approach: "[A] liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty." Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289–90 (7th Cir. 1985).

[129] An apparent exception is *Hidden Lake*, in which the Bankruptcy Court for the Southern District of Ohio sustained a formula-based prepayment fee that amounted to 23% of the outstanding principal of the loan on the basis that "loss to the lender would be hard to estimate *at the time the loan is closed* because of the inability to predict future interest rates and the uncertainty of the availability of a suitable substitute investment opportunity for the lender." *In re* Hidden Lake Ltd. P'ship, 247 B.R. 722, 729 (Bankr. S.D. Ohio 2000) (emphasis added).

[130] *See In re* Vanderveer Estates Holdings, Inc., 283 B.R. 122, 132 (Bankr. E.D.N.Y. 2002); *In re* Fin. Ctr. Assocs., 140 B.R. 829, 837 (Bankr. E.D.N.Y. 1992).

other, is meaningful under the Bankruptcy Code. If the obligation to pay a prepayment fee is treated as an obligation to pay "interest," a bankruptcy court does not have to go through section 506(b)'s "reasonableness" analysis, although it still has discretion to modify the size of the claim based on equitable considerations.[131] Moreover, in that event, an *under*secured creditor's claim for a prepayment fee would be covered by section 502(b)(2), which disallows unsecured claims for interest that has not matured as of the petition date.

The cases are surprisingly uniform on this issue: They state or assume that a prepayment fee is a "charge" or "fee" and that a no call does not give rise to anything covered by section 506(b)—neither "interest" nor a "charge" or a "fee."[132] To the extent that the cases deal with fixed prepayment fees that are divorced from actual damages, this reasoning makes sense. As discussed above, a prepayment clause that provides for a fixed fee is an option to pay something *other than* "interest" to the lender. A fixed prepayment fee, therefore, can sensibly be described as a "charge" or "fee."

The assumption that prepayment clauses generate "charges" is less sound as applied to no calls and yield maintenance provisions. A no call, as discussed in Part I, is simply an express confirmation that the parties to a loan agreement will honor the rule of perfect tender in time. The damages resulting from breach of a no call, therefore, are intended to place lenders in the same position they would occupy absent prepayment. Such damages are not a "charge" for breach of contract but rather a judicial estimate of the amounts needed to ensure that lenders receive the "interest" for which they bargained.

Prepayment clauses that contain yield maintenance formulas, as opposed to fixed prepayment fees, are obviously different from no calls insofar as they set forth the formula to be used in determining the amount owing to lenders in the event of

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[131] In United States v. Ron Pair Enters., 489 U.S. 235, 241 (1989), the Supreme Court held that the phrase "provided for under the agreement under which such claim arose" in section 506(b) does not modify the phrase "interest on such claim." Thus, an oversecured creditor is not, as a matter of statutory law, entitled to the rate of interest provided for in a loan agreement. Nonetheless, "[t]here is 'a presumption in favor of the contract rate subject to rebuttal based on equitable considerations.'" *E.g.*, *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546, 550 (Bankr. S.D.N.Y. 1998) (quoting *In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994).

[132] *See, e.g.*, *In re* Imperial Coronado Partners, Ltd., 96 B.R. 997, 1000 (B.A.P. 9th Cir. 1989) (contractual prepayment fee falls under section 506(b) since it is "charge provided for under the agreement"); *In re* Vest Assocs., 217 B.R. 696, 699 (Bankr. S.D.N.Y. 1998) (damages resulting from breach of no call not "charge"); Continental Sec. Corp. v. Shenandoah Nursing Home P'ship, 193 B.R. 769, 774 (W.D. Va. 1996); *see also* Norwest Bank Minnesota v. Blair Road Assocs., 252 F. Supp. 2d 86, 96 (D.N.J. 2003) ("[A] prepayment premium is not interest at all because it is not compensation for the use of money but a charge for the option or privilege of prepayment . . . ."). One apparent exception is the Bankruptcy Court's decision in *Kroh Brothers*. In that case, after determining that a prepayment fee resulting from a YMF was unenforceable to the extent it overcompensated the lenders, the Court disallowed the prepayment fee on the alternative ground that "postpetition interest should be allowed only until the principal amount is repaid." *In re* Kroh Bros. Dev. Co., 88 B.R. 997, 1001 (Bankr. W.D. Mo. 1988). The Court, therefore, apparently took the view that a prepayment charge was equivalent to post-petition interest. *See* W. Barry Blum, *The Oversecured Creditor's Right to Enforce a Prepayment Charge as Part of Its Secured Claim under 11 USC 506(b)*, 98 COM. L.J. 78, 84 (1993).

prepayment. Nonetheless, their purpose is fundamentally no different from that of a no call. Both clauses seek to put the lender in the same position as it would be if the borrower adhered to the original payment schedule. While some YMFs arguably overcompensate lenders by using a treasury-based reinvestment rate, the justification for doing so is that actual damages from prepayment are sufficiently unpredictable that a lender is entitled to some cushion in case it cannot reinvest immediately in a similar security.[133] Regardless of whether such formulas are valid under the law of liquidated damages, they are still intended to serve as a proxy for the *actual* damages that would be due and owing absent such a clause. Liquidated damages, after all, are nothing more than "[a]n amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches."[134]

The upshot of this analysis is that, as an economic matter, both the actual damages resulting from breach of a no call and the liquidated damages that result from a yield maintenance formula are the equivalent of the unmatured interest that a lender expects to receive through the term of a loan. As a result, it is at least arguable that such amounts should be viewed as "interest" under sections 502(b) and 506(b) of the Bankruptcy Code.

Treating no-call damages as "interest" under section 506(b) has the salutary effect of undercutting the cases under which prepayment fees are enforceable under section 506(b) as liquidated damages clauses while no-call damages are not enforceable because they are not "provided for under the [loan] agreement."[135] Those cases lead to a bizarre result, because they would enforce liquidated damages for breach of the rule of perfect tender in time, which are not necessarily enforceable under state law, but not *actual* damages for such breach, which should be awarded as a matter of course regardless of whether liquidated damages are proper.[136] It is inconceivable that an "actual damages" formula in a loan agreement is encompassed by section 506(b) whereas damages for breach of a no call, which are determined based on the same formula, are not.

By the same token, treating fees based on YMFs as interest, even though fixed prepayment fees are treated as "charges," makes sense because doing so treats fees based on YMFs the same way as damages for breach of a no call are treated: Since they both protect lost yield, they are both treated as "interest" under section 506(b). At the same time, such treatment distinguishes YMFs from what they are not—*i.e.*,

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[133] *See, e.g.*, *Vanderveer Estates Holdings*, 283 B.R. at 132

[134] BLACK'S LAW DICTIONARY 395 (8th ed. 2004).

[135] *See Vest Assocs.*, 217 B.R. at 699–700 (bankruptcy court cannot "read into a contract damage provisions which the parties themselves have failed to insert regarding the liquidation or calculation of damages arising out of the prepayment of a loan"); *Shenandoah Nursing*, 193 B.R. at 774 (no call not enforceable under section 506(b) since it is not contractual charge, fee, or cost).

[136] It is black-letter law that common law damages are awarded for breach of contract when the contract does not provide for enforceable liquidated damages. *E.g.*, Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1292 (7th Cir. 1985); RESTATEMENT (SECOND) OF CONTRACTS § 356, cmt. a (1981).

"charges" payable at the option of the borrower that are unconnected to the lenders' damages.

There is room to argue that even a fixed prepayment fee should be treated as "interest" for purposes of section 506(b). In *Smiley v. Citibank (South Dakota), N.A.*, the United State Supreme Court upheld a determination by the Comptroller of the Currency that a provision in the National Bank Act under which banks may charge "interest" allowed by state law encompasses credit-card late-payment fees.[137] In doing so, the Court concluded that "interest" can be defined broadly as any "compensation allowed by law, or fixed by the parties, for the use or forbearance of money or as damages for its detention."[138] The Court also noted that, in the relevant statutory provision, "the term 'interest' is not used in contradistinction to 'penalty,'" leaving open the possibility that a penalty could be treated as "interest."[139]

In section 506(b) of the Bankruptcy Code, the word "interest" clearly is used in contradistinction to "charge." That does not necessarily mean, however, that a fixed sum paid to a lender along with outstanding principal should be viewed as a "charge" as opposed to "interest." Although such a sum, unlike a YMF, is not intended to approximate lost interest, it is clearly compensation for the "use" of borrowed money (albeit to *repay* a loan rather than to continue depriving the lender of its capital). In addition, although a fixed fee may not approximate lost yield, it functions as a substitute for such yield, since it is paid to the lender in lieu of unmatured interest.

Treating all prepayment fees (including fixed fees) as "interest" would have the benefit of treating *all* compensation resulting from prepayment clauses in the same way, thus avoiding any need to draw subtle (and, in the view of some, illusory) distinctions between "true options," on the one hand, and liquidated damages, on the other. The downside of such an approach, however, is that fees that bear no necessary relation to future interest—and that are even called "charges" or "fees"—would be treated no differently from damages for breach of a no call and formulas intended to estimate such damages. One relatively crude approach, under which prepayment clauses necessarily yield "charges," would be replaced with another, under which the clauses yield "interest" no matter their form.

* * *

The case law applying section 506(b) to prepayment clauses, for all its diversity, is surprisingly uniform insofar as it treats all prepayment fees as "charges," favors prepayment fees over no calls and, for the most part, favors YMFs over fixed fees. Here, we have suggested an alternative approach that distinguishes

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[137] 517 U.S. 735 (1996) (deferring to Comptroller's determination as set forth in 61 Fed. Reg. 4869). In reaching its conclusion, the Supreme Court applied the deferential standard used to review agency determinations. *See* Chevron USA Inc. v. Nat'l Res. Def. Council, Inc., 467 U.S. 837, 842–45 (1984).

[138] *Smiley*, 517 U.S. at 745 (quoting Brown v. Hiatts, 82 U.S. 177, 185 (1873)).

[139] *Id*. at 746–47.

prepayment clauses by their function, such that no calls and YMFs are treated as "interest" and fixed fees are treated as options and as "charges" (or even as "interest" too). This approach, aside from recognizing that prepayment clauses have different functions depending on their form, avoids the anomalous result under which prepayment fees provide more protection to lenders than no calls.

IV. PREPAYMENT CLAUSES AND UNSECURED CREDITORS

If an *oversecured* creditor's claim based on a prepayment fee or a no call is encompassed by section 506(b) of the Bankruptcy Code, either as a "charge" or as "interest," that claim will be allowed notwithstanding section 502(b)(2)'s general disallowance of claims for unmatured interest.[140] Section 506(b), however, does not benefit creditors that are undersecured or unsecured. Moreover, to the extent that prepayment damages are considered a "charge" or a "fee" that is not both "provided for under the [loan] agreement" *and* "reasonable," section 506(b) is likewise inapplicable, regardless of the extent of a creditor's secured claim. This section deals with claims that are not governed by section 506(b). *First*, we consider whether section 506(b) is exclusive, such that a "charge," a "fee," or "interest" that is not allowed under section 506(b) should not be allowed even as an unsecured claim. *Second*, we discuss the application of section 502(b)(2), which disallows claims for unmatured interest, to prepayment fees and no calls.

A. The Relationship Between sections 506(b) and 502(b)(2)

To assess whether section 506(b) is the exclusive mechanism through which post-petition interest, fees, costs, or charges may be recovered, it is necessary to examine the Code's claims allowance provisions. To reiterate, the Code defines a "claim" as a "right to payment,"[141] and section 502(b)(1) requires a bankruptcy court, upon objection, to disallow claims that are unenforceable "under any agreement or applicable law."[142] Section 506(a)(1) distinguishes between allowed unsecured claims and allowed secured claims, and section 506(b) prescribes that "postpetition interest, fees, costs or charges be added as part of the allowed amount of an allowed secured claim to the extent that the claim is oversecured."[143]

Since section 502(b)(1) provides for allowance of any claim that is not unenforceable under an agreement or applicable law, and section 506(b) permits an oversecured creditor to include certain items in its *secured* claim, the

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[140] 4 COLLIER ON BANKRUPTCY ¶ 506.04[2] (15th ed. rev. 2006) ("[I]f a creditor is oversecured by $20,000, the creditor may only add up to $20,000 in postpetition interest to its claim. The balance, if any, would be treated as an unsecured claim, subject to disallowance under section 502(b)(2)."); Hillinger, *Story of YMPs*, *supra* note 6, at 457 ("[E]ven if a [yield maintenance provision] represents a right to unearned interest as of the petition date, that will not invalidate it if [its] holder is oversecured.").

[141] 11 U.S.C. § 101(5) (2006).

[142] 11 U.S.C. § 502(b)(1) (2006).

[143] 4 COLLIER ON BANKRUPTCY ¶ 506.04[1] (15th ed. rev. 2006).

straightforward reading of the Code is that, even if interest, fees, costs, or charges are not allowed as part of a *secured* claim under section 506(b), they should still be allowed as part of a creditor's *un*secured claim if a right to payment exists and is not extinguished by the Bankruptcy Code or state law. Recently, however, in the context of a dispute over an unsecured creditor's contractual right to recover attorneys' fees from a debtor, the Supreme Court considered, but did not decide, whether the opposite might be true—*i.e.*, whether section 506(b) might, by negative implication, prevent anyone besides an oversecured creditor from recovering post-petition interest, fees, costs, or charges.

Travelers Casualty & Surety Co. of America v. *Pacific Gas & Electric Co.*[144] involved a surety bond issued by Travelers to the California Department of Industrial Relations to guaranty the obligation of Pacific Gas and Electric Company ("PG&E") to pay workers' compensation benefits to injured employees.[145] To obtain that bond, PG&E had agreed to indemnify Travelers for any loss it suffered, including attorneys' fees incurred in protecting its rights.[146] When PG&E later filed for bankruptcy protection, Travelers objected to PG&E's reorganization plan and litigated with the debtor regarding the language in the plan that preserved Travelers' rights under the guarantee agreement.[147] The objection was settled, but Travelers filed a claim for the attorneys' fees incurred in litigating with the debtor.[148] The lower courts denied Traveler's claim for attorneys' fees based on *In re Fobian*,[149] a Ninth Circuit decision holding that attorneys' fees incurred in litigating issues of federal bankruptcy law were not recoverable from the debtor. In the Supreme Court, rather than defending the so-called *Fobian* rule, PG&E argued that section 506(b), which permits oversecured creditors to recover attorneys' fees provided for in an agreement with the debtor, necessarily *precludes* an unsecured creditor from recovering such fees. The Supreme Court refused to consider this argument because it was not the basis on which the Court granted *certiorari*, and reversed the Ninth Circuit's decision based solely on its disagreement with the *Fobian* rule.[150]

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[144] 127 S. Ct. 1199 (2007).
[145] *Id*. at 1202.
[146] *Id*.
[147] *Id*. at 1200, 1202.
[148] *Id*. at 1200.
[149] 951 F.2d 1149 (9th Cir. 1991), *cert. denied*, 505 U.S. 1220 (1992). For a thorough discussion of the *Fobian* decision, see Jennifer M. Taylor & Christopher J. Mertens, Travelers *and the Implications on the Allowability of Unsecured Creditors' Claims for Post-Petition Attorneys' Fees against the Bankruptcy Estate*, 81 AM. BANKR. L.J. 123, 128–39 (2007).
[150] 127 S. Ct. at 1207–08. There is substantial division in the case law on the issue that the *Travelers* Court declined to reach. For cases preventing unsecured creditors from recovering contractual attorneys' fees, see, for example, *In re Waterman*, 248 B.R. 567, 573 (B.A.P. 8th Cir. 2000); *In re Hedged-Invs. Assocs., Inc.*, 293 B.R. 523, 526 (D. Colo. 2003); *In re* Miller, 344 B.R. 769, 771–73 (Bankr. W.D. Va. 2006); *In re* Global Indus. Techns., Inc., 327 B.R. 230, 239 (Bankr. W.D. Pa. 2005); *In re* Pride Cos. L.P., 285 B.R. 366, 371–77 (Bankr. N.D. Tex. 2002); *In re Loewen Group Int'l, Inc.*, 274 B.R. 427, 444–45 (Bankr. D. Del. 2002); *In re El Paso Refinery, L.P.*, 244 B.R. 613, 616–17 (Bankr. W.D. Tex. 2000); *In re Smith*, 206 B.R. 113, 115 (Bankr. D. Md. 1997); *In re Woodmere Investors Ltd. P'ship*, 178 B.R. 346, 355–56 (Bankr. S.D.N.Y. 1995); *In re Birt*, 173 B.R. 346, 355–56 (Bankr. N.D. Ohio 1994); *In re Saunders*, 130 B.R. 208, 210 (Bankr. W.D. Va. 1991); *In re Alden*, 123 B.R. 563, 564 n.1 (Bankr. E.D. Mich. 1990); *In re*

Since *Travelers* was decided, the First Circuit has had occasion to consider the relationship between sections 506(b) and 502(b) in a case involving prepayment fees. That case, *Gencarelli v. UPS Capital Business Credit*,[151] involved a challenge by a solvent debtor to a secured creditor's claim to a fixed prepayment fee equal to the 3% of outstanding principal. The bankruptcy court had concluded that section 506(b) creates a uniform federal standard of "reasonableness," and that the fee at issue was not "reasonable" under that standard.[152] On appeal, the creditor argued that, even if the fee at issue was not "reasonable" under section 506(b), it was still enforceable under state law and as an unsecured claim under section 502(b). The First Circuit agreed, and remanded the cause to the bankruptcy court to determine whether the prepayment fee at issue was enforceable under Rhode Island law.[153]

En route to vacating the bankruptcy court's ruling, the court of appeals concluded that "[s]ection 502(b), not section 506(b), affords the ultimate test for allowability, and any claim satisfying that test is, at the very worst, collectible as an unsecured claim."[154] The court found support for this conclusion in commentary,[155] case law,[156] and what it called "common sense."[157]

Sakowitz, Inc., 110 B.R. 268, 272 (Bankr. S.D. Tex. 1989); *In re Canaveral Seafoods, Inc.*, 79 B.R. 57, 58 (Bankr. M.D. Fla. 1987); *Matter of Mobley*, 47 B.R. 62, 63 (Bankr. N.D. Ga. 1985); *In re Woerner*, 19 B.R. 708, 712–13 (Bankr. D. Kan. 1982). For cases allowing recovery of attorneys' fees, see, for example, *In re Fast*, 318 B.R. 183, 194 (Bankr. D. Colo. 2004); *In re New Power Co.*, 313 B.R. 496, 510 (Bankr. N.D. Ga. 2004); *In re Hunter*, 203 B.R. 150, 151 (Bankr. W.D. Ark. 1996); *In re Byrd*, 192 B.R. 917, 918–19 (Bankr. E.D. Tenn. 1996); *In re Independent American Real Estate, Inc.*, 146 B.R. 546, 555 (Bankr. N.D. Tex. 1992); *In re A. Tarricone, Inc.*, 83 B.R. 253, 254–55 (Bankr. S.D.N.Y. 1988); *Liberty Nat. Bank and Trust Co. of Louisville v. George*, 70 B.R. 312, 316–17 (W.D. Ky. 1987); *In re Ladycliff College*, 56 B.R. 765, 769 (S.D.N.Y. 1985); *In re Tri-State Homes, Inc.*, 56 B.R. 24, 25–26 (Bankr. W.D. Wis. 1985); *In re Ely*, 28 B.R. 488, 491–92 (Bankr. E.D. Tenn. 1983); *In re Missionary Baptist Foundation of America, Inc.*, 24 B.R. 970, 971 (Bankr. N.D. Tex. 1982). Since the Supreme Court decided *Travelers*, courts have continued to disagree on the question of whether an unsecured creditor may collect post-petition attorneys' fees from the estate. *Compare In re* Qmest, Inc., No. 04-41044, 2007 Bankr. LEXIS 1845 (Bankr. N.D. Cal. May 17, 2007) (allowing unsecured claim for post-petition attorneys' fees; section 506(b) interpreted to apply only to secured claims and not to disallow categories of unsecured claims), *with In re* Elec. Mach. Enter., Inc., 371 B.R. 549 (Bankr. M.D. Fla. July 6, 2007) (relying on section 506(b) to disallow unsecured claim for attorneys' fees).

[151] No. 06-2700, 2007 WL 2446883 (1st Cir. Aug. 30, 2007).

[152] *In re* Bess Eaton Donut Flour Co., Nos. 04-10630, 04-10682, 2005 WL 1367306, at *3 (Bankr. D.R.I. Jan. 19, 2005), *aff'd sub. nom.* UPS Capital Business Credit v. Gencarelli, No. 1:05-cv-00039, 2006 WL 3198944, at *3 (D.R.I. Nov. 3, 2006).

[153] *Gencarelli*, 2007 WL 2446883, at *7.

[154] *Id.* at *4.

[155] *Id.* (citing 4 COLLIER ON BANKRUPTCY § 506.04[3], at 506–120 to 506–121 (15th ed. 2007) ("If a creditor is generally entitled to add postpetition . . . fees to its secured claim because of the existence of an oversecurity, and the claim for . . . fees is valid under the agreement and applicable state law, but is disallowed by the bankruptcy court for want of reasonableness, the amount so disallowed should be treated as an unsecured claim against the estate."); Daniel R. Cowans, *Bankruptcy Law & Practice* § 17.22, at 305 (7th ed.1999) (arguing that the "limits of § 506(b) are applicable to the secured nature of the claim and any excess under the contract may be filed as an unsecured claim").

[156] *Gencarelli*, 2007 WL 2446883, at *4 (citing *In re* Welzel, 275 F.3d 1308 (11th Cir. 2001) (en banc) (fees enforceable under state law but not "reasonable" under section 506(b) should be allowed as an unsecured claim); *In re* 268 Ltd., 789 F.2d 674 (9th Cir. 1986) (lender may seek as unsecured claim damages not recoverable as a secured claim under section 506(b)). The First Circuit also relied on *United Merchants*,

Crucially, the First Circuit limited its holding to solvent cases, where creditors are paid in full regardless of their priority.[158] In footnote 3 of its decision, the court further explained that, because "the balance of the equities may be different if unsecured creditors are at risk of collateral damage," it had not decided the issue left open in *Travelers—i.e.*, "whether an unsecured creditor can enforce a contractual right to post-petition fees against the estate of an insolvent debtor under section 502."[159] In limiting its holding, however, the court suggested that *equity* may permit the reduction of an unsecured creditor's claim to post-petition fees, costs or charges in an insolvent case. The court did *not* suggest that section 506(b) implicitly *precludes* such an unsecured claim. Indeed, the court's decision supports the opposite conclusion, in insolvent as well as solvent cases. The crux of the First Circuit's opinion is that "it makes sense that oversecured creditors should not be allowed to *prioritize* unreasonable fees, costs, and charges; it does not make sense that oversecured creditors should be penalized by disallowing those fees, costs, and charges altogether—especially when unsecured creditors can collect them."[160] If section 506(b) *precluded* unsecured claims for post-petition fees, charges and costs, the last clause in the court's sentence would be incoherent: in that event, unsecured creditors would *not* be able to collect any fees, charges or costs, let alone unreasonable ones. The first part of the court's sentence, however, makes clear that section 506(b) does not have such a preclusive effect. According to the court, rather than *disallowing* any claim, section 506(b) merely prevents an oversecured creditor from asserting a *priority* claim to unreasonable amounts. Section 506(b), therefore, exists to protect unsecured creditors in insolvent cases, whose recoveries would be reduced if unreasonable fees or charges were included in an allowed secured claim. Section 502(b), in turn, permits secured and unsecured creditors alike to file unsecured claims based on state law rights; while those claims might be disallowable in insolvent cases based on equitable considerations, section 506(b) has no bearing on them. A close reading of the First Circuit's opinion, therefore, belies the notion that its reasoning is limited to solvent cases. The equities referenced by the court have to be considered in insolvent cases precisely because, under the First Circuit's reasoning, section 506(b) has no effect on unsecured claims.

In *Gencarelli*, the First Circuit succinctly articulated the argument that section 506(b) does not trump section 502(b) as far as unsecured claims are concerned. The opposing argument—*i.e.*, that section 506(b) precludes unsecured claims for

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which held, under the old Bankruptcy Act, that unsecured creditors are entitled to an allowable claim for bargained-for "collection costs" in connection with litigation conducted during the bankruptcy. 674 F.2d 134, 137–38 (2d Cir. 1982). By the time the Second Circuit ruled, section 506(b) of the Bankruptcy Code had been enacted, but the *United Merchants* court interpreted that provision to address the rights of secured creditors only. *Id*.

[157] *Gencarelli*, 2007 WL 2446883, at *5.

[158] *Id*. at *5, *7.

[159] *Id*. at *5 n.3.

[160] *Id*. at *5 (emphasis added).

attorneys' fees or other fees and charges—rests largely on the Supreme Court's decision in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*[161] In that case, the Supreme Court considered whether an undersecured creditor is entitled to "adequate protection," in the form of compensation, for lost income resulting from the delay in foreclosure and reinvestment resulting from Bankruptcy Code's automatic stay. En route to concluding that undersecured creditors have no such entitlement, the Court characterized section 506(b) as a provision that has the "substantive effect of denying undersecured creditors postpetition interest on their claims."[162] According to the Court, because section 506(b) permits only *over*secured creditors to collect interest "to the extent of" their security cushion, section 362(d)(1) of the Code, which provides for "adequate protection," could not possibly have been intended to allow *under*secured creditors to collect interest on their collateral as a whole.[163]

In isolation, the language in *Timbers* explaining the "substantive effect" of section 506(b) would appear to support the contention that section 506(b) prevents unsecured creditors from receiving that which oversecured creditors may receive under section 506(b). A crucial problem with such reliance on *Timbers*, however, is that the *Timbers* decision goes on to explain that an undersecured creditor, lacking a security cushion, "falls within the general rule disallowing postpetition interest," which is found in section 502(b)(2).[164] In other words, while the Court noted that section 506(b) has the indirect effect of denying interest to unsecured creditors because it applies only to oversecured creditors, *section 502(b)(2)* was presented as the provision that actually has the effect of disallowing the creditors' unsecured claim.[165] Section 506(b), therefore, does not appear to divest unsecured creditors of any rights, even under *Timbers*; if it did, section 502(b)(2)'s disallowance of a claim for unmatured interest would be superfluous.

Whether section 506(b), on its own, precludes allowance of claims for post-petition interest, charges, or fees that fall beyond its purview is a subject for another article.[166] Nonetheless, because there are clearly substantial arguments *against* that

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[161] 484 U.S. 365 (1988).

[162] *Id*. at 372.

[163] *Id*. at 372–73.

[164] *Id*. at 372–73.

[165] *See Gencarelli*, 2007 WL 2446883, at *4 n.2 (dismissing *Timbers* on the basis that it "dealt with claims for post-petition interest, which—unlike the prepayment penalties at issue here—are made unavailable as unsecured claims by an explicit statutory provision" [*i.e.*, section 502(b)(2))].

[166] The division in the case law dealing with unsecured claims for post-petition attorneys' fees suggests that some courts are likely to reject the notion that unsecured creditors can collect a prepayment fee from an insolvent debtor. *Cf. Gencarelli*, 2007 WL 2446883, at *4 n.1 ("[T]here is no principled basis for treating attorneys' fees differently from prepayment penalties in this context."). In an article published since *Travelers* was decided, two authors have argued that the Supreme Court should and probably would rule that an unsecured creditor's claim for post-petition attorneys' fees should be disallowed under section 506(b). *See* Taylor & Mertens, *supra* note 149, at 139–63. In addition to relying on both *Timbers* and section 506(b)'s arguable implication that unsecured creditors may not recover fees that accrue post-petition, the authors rely on (i) Congress's express award of post-petition attorneys' fees in specific situations, *id*. at 148–49 (citing sections 502(b), 330, 503(k), 362(k), and 523(d)), (ii) pre-Code practice relating to attorneys' fees, *id*. at

conclusion—including those embraced by the First Circuit in *Gencarelli* (albeit in a solvent case)—we assume for purposes of this article that section 506(b) is *not* exclusive, and that an unsecured claim arising out of a prepayment clause will be allowed unless barred by section 502(b)(2).

B. Prepayment Clauses under section 502(b)(2)

Under section 502(b)(2) of the Bankruptcy Code, a claim for "unmatured interest" is not allowable.[167] This subsection considers whether claims based on prepayment fees and no calls, if not allowable under section 506(b), should be disallowed as claims for "unmatured interest."

1. Case Law

Most cases to consider the issue have concluded that claims based on prepayment clauses are *not* claims for unmatured interest.[168] The basic rationale for these decisions, as summarized in one case, is as follows: "Prepayment amounts, although often computed as being interest that would have been received through the life of the loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract."[169] In other words, an obligation to pay a prepayment charge is triggered by the prepayment itself, and therefore "matures" as soon as the prepayment occurs.[170] At least one court has applied the same logic to no calls, apparently concluding that common-law damages, like liquidated damages, mature at the time of breach.[171]

The minority view is that a claim based on a prepayment fee *is* a claim for unmatured interest. According to one court that embraced this view, "[a]s an attempt to compensate the lender for potential loss in interest income, [a lender's] claim for a prepayment penalty is not allowed under . . . § 502(b)(2)."[172] The same

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155–59, and (iii) indeterminate policy considerations favoring "equality of distribution" among creditors and efficiency, *id.* at 160–61. At least two of these arguments, namely those based on Congress's express treatment of attorneys' fees in other statutory provisions and pre-Code practice, do not necessarily apply to prepayment fees. The other arguments, for reasons discussed in the body of this section, are of questionable merit.

[167] 11 U.S.C. § 502(b)(2) (2006).

[168] *In re* Lappin Elec. Co., Inc., 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000); *In re* Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); *In re* Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987); *In re* 360 Inns. Ltd., 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987).

[169] *Outdoor Sports Headquarters*, 161 B.R. at 424.

[170] *Skyler Ridge*, 80 B.R. at 508 (prepayment premiums fully mature upon prepayment and therefore are not unmatured interest); *360 Inns, Ltd.*, 76 B.R. at 576 ("[T]he prepayment penalty was not unmatured interest as contemplated in § 502(b)(2), inasmuch as the prepayment penalty was activated and *matured* once the plan of reorganization proposed to prepay [the lender's] debt.").

[171] *In re* Calpine Corp., 365 B.R. 392, 399 (Bankr. S.D.N.Y. 2007) (citing *Lappin*, 245 B.R. at 330).

[172] *In re* Ridgewood Apartments, 174 B.R. 712, 721 (Bankr. S.D. Ohio 1994). In another case, *In re* Hidden Lake Ltd. P'ship, 247 B.R. 722 (Bankr. S.D. Ohio 2000), the same judge ruled that a claim for a prepayment premium was *not* a claim for unmatured interest because it arose as the result of the mortgagee's

logic has been applied to damages for breach of a no call, which are likewise intended to compensate lenders fully for lost interest income.[173]

2. Analysis of Case Law

The cases holding that claims based on prepayment fees and no calls are not claims for unmatured interest are predicated on the theory that a right to payment that has already been triggered by definition is not "unmatured"; thus, even though the payment required by a no call or a makewhole may be equivalent to the present value of unmatured interest, it still is not covered by section 502(b)(2).

If accepted, this theory would appear to undermine the efficacy of section 502(b)(2). One crucial effect of that provision is that the rule of perfect tender does not apply in bankruptcy. Thus, whereas a non-bankrupt borrower cannot prepay a loan (absent consent) without at least paying the lender whatever unmatured interest it stands to lose, a bankrupt debtor can do precisely that. Allowing the unsecured claims resulting either from no calls (which memorialize the rule of perfect tender) or YMFs (which simplify the damages analysis required by a no call) would effectively unwind section 502(b)(2). Although bankruptcy might prevent specific enforcement of a no call, the lender would be entitled to use a no call or a YMF to recover the exact lost interest that section 502(b)(2) disallows.

Reading section 502(b)(2) to disallow a claim for unmatured interest, but not a claim for the present value of that interest, is difficult to defend. A better reading of section 502(b)(2) is that it disallows unsecured claims for interest or its equivalent that are "unmatured" as of the *petition date*. Under that reading, if the right to the present value of interest "matures" after the petition date (for example, when a no call is breached), section 502(b)(2) could not be avoided by distinguishing that right from the right to unmatured interest that existed just before the breach.

Where a borrower negotiates a true "option" to prepay, such that any prepayment fee cannot be as easily characterized as "interest," section 502(b)(2)'s applicability is less apparent. As discussed in Part III, when parties to a loan agreement agree on a fixed prepayment fee that is unconnected to any expected damages amount, there is a solid basis to treat the prepayment clause at issue as an option and the fee as a "charge." On the other hand, where parties use a formula aimed at liquidating damages, the fee resulting from the formula is difficult to distinguish from damages for breach of a no call, and hence from "interest." Correspondingly, the case for treating a fixed prepayment fee as unmatured interest under section 506(b)(2) is weaker than the case for treating a YMF as such.[174] Of

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pre-petition acceleration. In doing so, however, the court noted that, absent pre-petition acceleration by the lender, "the result might be different." *Id*. at 728–30.

[173] Cont'l Sec. Corp. v. Shenandoah Nursing Home P'ship, 188 B.R. 205, 213–14 (W.D. Va. 1995) (enforcement of no call would clash with section 502(b)(2)'s disallowance of unmatured interest).

[174] *Lappin Elec. Co*., 245 B.R. at 330 (concluding that prepayment fee was not covered by section 502(b)(2); "In this case, the charge is independent of the amount owed at termination, thus negating any characterization as interest.").

course, if *all* claims based on prepayment clauses were treated as "interest," then all such claims would be barred by section 502(b)(2) to the extent they are unsecured.

V. PREPAYMENT CLAUSES IN SOLVENT CASES

In discussing the application of sections 506(b) and 502(b)(2) of the Bankruptcy Code to prepayment fees and no calls, we have assumed (a) that bankruptcy judges have discretion under section 506(b) to reduce or disallow "unreasonable" prepayment fees and (b) that section 502(b)(2)'s disallowance of unmatured interest is operative. These assumptions, as well as other assumptions predicated on the Bankruptcy Court's equitable discretion over the distribution of estate property, are not applicable in solvent cases.

In a solvent case, a "bankruptcy judge does not have free floating discretion to redistribute rights in accordance with his personal views of justice and fairness"; rather, "it is the role of the bankruptcy court to enforce the creditors' contractual rights."[175] The reason for this distinction between solvent and insolvent cases is that, in insolvent cases, bankruptcy courts need to facilitate the distribution of "a pie that is too small to allow each creditor to get the slice for which he originally contracted"; as a result, as between secured and unsecured creditors, "there is a question whether one creditor should get interest while another doesn't even recover principal."[176] In solvent cases, on the other hand, any disallowed contract interest inures to equityholders.[177]

The distinction between solvent and insolvent cases, as it manifests itself in section 506(b), has deep roots in the law of default and compound interest owing to secured creditors. In *Ruskin v. Griffiths*,[178] the Second Circuit held that a solvent debtor was obligated to pay default interest to its secured creditors. In doing so, the Court distinguished *Vanston Bondholders Protective Committee v. Green*,[179] in which the Supreme Court disallowed a claim for compound interest, on the basis that "[i]n *Vanston* the debtor was insolvent, and in our case it appears the debtor is solvent,"[180] Because enforcement of the parties' agreement would not harm junior creditors, the Court concluded that it would be "the opposite of equity to allow the

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[175] *In re* Dow Corning Corp., 456 F.3d 668, 679 (6th Cir. 2006) (internal quotation marks omitted); *accord* Gencarelli v. UPS Capital Bus. Credit, No. 06-2700, 2007 WL 2446883, at *5 (1st Cir. Aug. 30, 2007) ("When the debtor is solvent, 'the bankruptcy rule is that where there is a contractual provision, valid under state law, . . . the bankruptcy court will enforce the contractual provision.'" (quoting Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp., 679 F.2d 264, 269 (1st Cir. 1982))).

[176] *In re* Chicago, Milwaukee, St. Paul and Pac. R. Co., 791 F.2d 524, 528 (7th Cir. 1986) (Posner, J.). *See Gencarelli*, 2007 WL 2446883, at *3 ("Normally, priority is of tremendous importance in bankruptcy cases. It is irrelevant, however, where the debtor is solvent and can afford to pay all claims (secured and unsecured) in full.").

[177] *See* Hillinger, *supra* note 6, at 455 ("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.").

[178] 269 F.2d 827 (2d Cir. 1959).

[179] 329 U.S. 156 (1946).

[180] *Ruskin*, 269 F.2d at 830.

debtor to escape the expressly-bargained-for result of its [Chapter XI petition]."[181] Based on this same reasoning, numerous courts have declined to modify the rights of oversecured creditors to default interest in solvent cases, notwithstanding the courts' authority under section 506(b) to fix interest rates.[182]

With the exception of the First Circuit's decision in *Gencarelli*, solvency generally has not been emphasized in cases considering the application of prepayment clauses; however, the logic of the default interest cases applies with equal force to prepayment clauses. Thus, in the unlikely event that state law would require specific performance of a no call, there is little basis to permit a solvent debtor to redeem its debt.[183] By the same token, in the "admittedly rare" case that the debtor proves solvent, both undersecured and wholly unsecured creditors should be entitled to recover interest, notwithstanding section 502(b)(2).[184]

Finally, as noted in *Gencarelli*, there is no basis in a solvent case to limit a prepayment fee—whether it is characterized as a "charge" or as "interest"—to the lender's actual damages, unless state law does so. In an *in*solvent case, there are multiple reasons to limit any prepayment fee to the lender's actual damages. From an *ex post* standpoint, it is arguably unfair for a senior lender to receive more than the interest for which it bargained while a junior lender does not even receive its principal. Moreover, from an *ex ante* standpoint, a borrower is less likely to pursue value-enhancing refinancing transactions in the face of a prepayment fee that *exceeds* the lenders' actual damages than one that is equal to such damages. In a solvent case, however, "fairness" among creditors is not an issue, and whether a borrower pursues transactions that benefit equityholders is beyond the purview of the bankruptcy court. Because the parties' state law entitlements should be respected, section 506(b) is ultimately irrelevant: The bankruptcy estate possesses funds sufficient to pay all claims (secured and unsecured) in full, and therefore "no useful purpose would be served by inquiring into whether the prepayment penalties are reasonable (and, thus, deserving of priority) within the contemplation of section

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[181] *Id.* at 832.

[182] *E.g.*, *In re* 139–141 Owners Corp., 313 B.R. 364, 369 (S.D.N.Y. 2004) ("*Ruskin* remains the law of the Second Circuit and applies to cases decided under the Bankruptcy Code.") (enforcing oversecured creditors' claim to default interest); *In re* Vanderveer Estates Holding, 283 B.R. 122, 134 (Bankr. E.D.N.Y. 2002); *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546, 551 (Bankr. S.D.N.Y. 1998).

[183] The relevant case law does not squarely address the issue, but obliquely supports the opposite result. *See* Continental Sec. Corp. v. Shenandoah Nursing Home P'ship, 193 B.R. 769, 779 (W.D. Va. 1996) (affirming Bankruptcy Court's holding that prepayment prohibition is not specifically enforceable where the debtor "was solvent"); *In re* 360 Inns, Ltd., 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987) (authorizing repayment during no-call period where "the debtor was solvent").

[184] This position has strong support in the case law. *See* United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 379 (1988); *see, e.g.*, *In re* Carter, 220 B.R. 411, 418 (Bankr. D.N.M. 1998) ("[I]nterest is appropriately awarded to an unsecured creditor when there is a solvent debtor and there is a surplus produced by the estate."). It is also mandated by the statute. Section 726 of the Bankruptcy Code, which delineates the order in which property is distributed in a liquidation scenario, specifically states that, before the debtor itself can receive property, "interest" on all unsecured claims must be paid at the legal rate. 11 U.S.C. § 726(5) (2006). As a result, in a *solvent* chapter 11 case, depriving an unsecured creditor of interest would not be sustainable under the "best interests" test, which requires all creditors to be paid at least as much as they would in a liquidation. *See* 11 U.S.C. § 1129(a)(7)(A)(ii) (2006).

506(b)."[185] The effect of prepayment clauses in solvent cases, therefore, should be an issue of state law alone.

CONCLUSION

In this article, we have summarized the case law governing prepayment clauses in bankruptcy and analyzed the assumptions underlying that law, including the assumption that prepayment fees can be categorized as "charges" under section 506(b) while no calls fall outside that provision. Based on that analysis, we have concluded that treating all prepayment fees as liquidated damages clauses that yield "charges," and no calls as unenforceable prohibitions not covered by section 506(b), has led to anomalous results. Under the present law, liquidated damages clauses are easier to defend than clauses that simply protect common-law damages; in addition, fixed prepayment fees that understate actual damages are harder to defend than formulas that approximate actual damages (thus deterring transactions that could benefit the estate).

The law in this area would benefit if prepayment clauses were analyzed according to their particular functions. Thus, whereas both no calls and prepayment fees that function as no calls should be treated as clauses that protect "interest" under section 506(b), fixed prepayment fees, especially if they are relatively low, are most logically treated as alternative performance clauses and as "charges." Section 506(b), therefore, should extend *both* to prepayment fees (however calculated) and to no calls. Section 502(b)(2), moreover, if interpreted to bar any claims based on any prepayment clauses, should only bar claims that are the equivalent of "interest"; the provision should not affect fixed fees that are divorced from a lender's expected yield. Finally, whereas the automatic acceleration resulting from bankruptcy might prevent enforcement of a prepayment clause if the prepayment at issue is inevitable, it should not deprive a lender of a prepayment fee where the borrower is repaying its debts simply to improve its balance sheet, precisely what a prepayment clause is intended to prevent. Ultimately, except when the Bankruptcy Code specifically deprives creditors of state-law rights, as in section 502(b)(2), bankruptcy should rarely be used to deprive lenders of their claims under a prepayment clause, whatever its form.

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[185] Gencarelli v. UPS Capital Bus. Credit, No. 06-2700, 2007 WL 2446883, at *7 (1st Cir. Aug. 30, 2007).