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NEW YORK
REAL ESTATE JOURNAL

Prepayment Provisions in Loan Documents - The Effect on a Sale or Refinance

By Gary C. Hisiger

As 2005 begins, many real estate investors are reviewing their portfolios. As part of this review, the real estate investor considers which properties to hold onto, which properties to sell and which properties to refinance. As part of this consideration, the investor will consider many things such as taxes payable on a sale and how the money can be redeployed following a sale or refinance. One other item that the sophisticated investor should consider in this analysis is any prepayment penalty which may be due should the loan secured by the investor's property be paid off early.

Prepayment provisions in conventional commercial mortgage loans generally take two forms. One, the more straightforward, is a percentage of the principal being prepaid. This is usually done on a scale which is set forth in the loan documents. For example, in a five year loan, the scale would typically be 5% the first year, declining 1% per year for each year that the loan is outstanding.

The second type of prepayment penalty is calculated pursuant to a yield maintenance formula. A yield maintenance penalty is commonly referred to by the lender as a "make whole"provision. Under a yield maintenance clause, the borrower is required to make a payment to the lender designed to make the lender whole for the loss of the lender's bargain. This is supposed to compensate the lender for the difference between the interest on the original loan and the yield available on U.S. Treasury instruments at the time pf prepayment.

In recent years, due to the decline, in some cases, to historically low levels of interest, the yield maintenance penalties due by some borrowers to their lenders have been extremely large. This has led some borrowers to challenge the legality of the yield maintenance premium in their loan documents.

Generally, these challenges have been unsuccessful. Courts have generally held that prepayment is a privilege which is bargained for when the loan documents were executed. The premium component of the prepayment privilege is part of that bargain. Thus, it is important for the investor to consider the impact of the prepayment premium when deciding whether or not to sell or refinance a property.

In a bankruptcy context, however, the result may be different. If the borrower or seller is a debtor in a bankruptcy proceeding, the prepayment premium may not be enforced. This is because many bankruptcy courts have held that a commercial borrower may seek, as part of its reorganization, to sell its property free and clear of liens and without the payment of a prepayment premium, even if one is set out in the loan documents. Other courts have held that if the prepayment premium does not reflect the actual damages incurred by the lender, the premium should be disallowed as a windfall to the mortgage lender at the expense of the unsecured creditors. All of these cases are fact specific and should be reviewed carefully with counsel if the borrower finds itself in a bankruptcy situation facing a yield maintenance penalty.

It is a rare time that the decision to sell or refinance a property should be dictated by the existence of a prepayment penalty. Other factors such as the need for capital, the price being paid (if a sale), the amount being loaned (if a mortgage) and the tax effect of a transaction often play larger factors in the investors decision making process. The prepayment penalty should, however, be one factor that is carefully analyzed in any sale or refinancing transaction where a prior mortgage is being repaid.

Gary C. Hisiger is a partner at Moritt Hock Hamroff & Horowitz LLP in Garden City, N.Y. He can be reached at (516) 873-2000 or at ghisiger@moritthock.com.