Banking Update

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Prepayment Fee Provisions: Enforceable or Not?

A prepayment is a prepayment is a prepayment, right?

Not necessarily. In determining the enforceability of prepayment fee provisions, courts historically have drawn a distinction between the borrower's voluntary prepayment of a loan (i.e., a refinancing) and so-called "involuntary" prepayments, such as application of collateral proceeds or funds received through enforcement actions after a lender's acceleration of the loan due to borrower's default, the application of insurance proceeds after damage to the property or the application of condemnation awards. The wording of the prepayment provision in your loan documents, as well as state law, affect whether you can collect the prepayment fee in connection with a voluntary prepayment or a so-called "involuntary" prepayment.

This article discusses the general enforceability of prepayment provisions under state law in connection with commercial real estate loans. For purposes of this article, a "commercial real estate loan" refers to a loan made to a borrower for commercial purposes, which is secured by a mortgage or deed of trust on commercial real estate or agricultural real estate. This article does not address state or federal law regulating consumer loan transactions or consumer loans secured by deeds of trust or mortgages on residential real estate.

Courts generally have enforced prepayment fee provisions in connection with the borrower refinancing a loan with another lender prior to the maturity date. Courts have been hesitant, however, to enforce a prepayment fee provision when the borrower defaulted on the loan, the lender accelerated the debt prior to maturity and the lender added the prepayment fee to the outstanding amount of the debt due for purposes of trying to collect the debt due from the borrower.

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This distinction arose because:

> [p]rior to the mid-1980s, it was rare for the prepayment clauses in commercial mortgages to deal specifically with prepayment incident to acceleration. Hence, lenders who claimed prepayment fees upon acceleration had only a slender contractual basis for doing so. They could argue that the loan was indeed being paid prior to its scheduled maturity and hence that the fee had been earned, but they could point to no contract language so stating. They usually lost these cases, typically on the grounds that the clause was not intended to cover "involuntary" prepayments; having been accelerated by the lender, the loan was now mature, and thus that payment was not "pre-" in the sense of being in advance of maturity, or that the lender's acceleration constituted a waiver of the prepayment fee.[1]

In response to this line of cases, lenders revised their loan documents to expressly provide for the collection of a prepayment fee in connection with "involuntary" prepayments. As a result of such revisions, a number of courts in recent years have enforced provisions in loan documents allowing a lender to collect a prepayment fee in connection with the acceleration of the loan after default. Many courts that have enforced the post-acceleration "prepayment" fees did so by interpreting the prepayment fee provision to be a liquidated damages clause that enabled the lender to collect the fee as a result of the borrower's breach of contract.

The case law on the enforceability of prepayment fee provisions continues to vary from state to state, particularly when the controlling cases have been based on loan documents that do not expressly provide for a prepayment fee in connection with "involuntary" prepayments. Generally, a court will enforce a prepayment fee provision in loan documents when the borrower initiates the early prepayment of the loan, unless the prepayment fee violates a state statute prohibiting prepayment fees or the fee is unreasonably large or unconscionable. In addition, a "prepayment" fee in connection with an "involuntary" prepayment generally is not enforceable if the loan documents do not expressly provide for the fee in those circumstances. If, however, the loan documents expressly provide for the prepayment fee in connection with an "involuntary" prepayment and the fee does not violate a state statute prohibiting the fee, state courts are split on whether the lender can collect the prepayment fee and whether it can be collected in all "involuntary" prepayment situations. The state courts do agree, however, that even if the provision is enforceable, they will not enforce the payment of a fee that is unreasonably large or unconscionable.

So, what's a lender to do? First, become familiar with your state law restrictions on collecting prepayment fees in connection with commercial real estate loans. If you make loans secured by real estate in other states, become familiar with those state laws too. You should be aware of the fact that some state courts have not ruled on this issue for several years and the "old" line of cases prohibiting the collection of a prepayment fee in connection with so-called 'involuntary" prepayments is still controlling law in those states.

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Second, review the prepayment provision in your loan documents. If your bank expects to collect a prepayment fee in connection with both voluntary prepayments and "involuntary" prepayments, the loan documents should clearly and expressly state that. For example:

> "Borrower will pay to Bank the prepayment fee in connection with any repayment of the unpaid

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1 Dale A. Whitman, Mortgage Prepayment Clauses: An Economic and Legal Analysis, 40 UCLA L. REV. 851, 908 (1992).

principal sum of the Note in whole or in part prior to the date on which repayment is due under the terms and conditions of the Note, including without limitation any such repayment (a) following Bank's exercise of its rights upon an event of default and acceleration of the maturity date, whether or not foreclosure proceedings were commenced or (b) resulting from the application of insurance proceeds or condemnation awards."

Because state law varies on the collection of a prepayment fee in connection with "involuntary" prepayments, you may not be able to collect the prepayment fee in every situation. The key is to protect your bank's ability to collect those fees by carefully drafting a prepayment fee provision so the borrower understands the prepayment situations in which you will seek to collect the prepayment fee. ■

Jacqueline A. Pueppke
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How the New Transfer-on-Death Deed Rules Affect Your Bank

On April 5, 2012, Nebraska Governor Dave Heinemen signed the Nebraska Uniform Real Property Transfer on Death Act (the "Act") into law. This law was effective as of January 1, 2013.

Upon your death, a Transfer of Death ("TOD") deed allows you to transfer real estate to your designated beneficiaries. Similar to other beneficiary designations, the TOD deed will trump your Last Will and Testament and bypass the probate court process. Bankers should be aware of the operations and effects of TOD deeds as customers will begin using such deeds as part of their estate planning.

TOD Deed – Impact During Lifetime

While you must sign and record the TOD deed during your lifetime, it has no effect until your death. During the transferor's life, the TOD deed does not give away any ownership interest of the transferor and does not create an enforceable future interest for the designated beneficiaries. Like most other beneficiary designations, the TOD deed can be changed or revoked at any time during your lifetime. You may still sell or mortgage the property during your lifetime. The TOD deed has no effect if you do not own the property upon your death; in the event you own the property in joint tenancy, the transferor must be the last surviving joint tenant.

Creation and Recording of TOD Deed

The TOD deed must include certain specific elements required by the Act, including a statement that the transfer to one or more beneficiaries will occur at the transferor's death. In addition, similar to the signing of a will, the owner must complete the instrument with certain formalities. This means that the transferor must have the same mental capacity necessary to sign a will, two disinterested witnesses must attest to the transferor's signature and a notary public must acknowledge these signatures.

Once the document is properly drafted and executed, the TOD deed *must be recorded with the Register of Deeds within 30 days of the signing date and before your death*. It also must be recorded in each county where the property is located. If you do not meet those requirements, the TOD deed will be invalid and have no effect.

TOD Deed – Change or Revocation

By statute, all TOD deeds must be revocable. Because beneficiaries of a TOD deed have no rights to the property during the property owner's lifetime, they cannot prevent the owner from revoking the deed. There are a number of ways to revoke a TOD deed. A TOD deed would be revoked by a subsequent TOD deed or an instrument of revocation meeting the formalities of execution discussed above. The TOD deed would also be revoked upon the owner's sale of the property during his or her lifetime.

Similarly, a transferor's divorce would automatically revoke a TOD deed made in favor of a former spouse.

TOD Deed – Impact upon Death

Upon the transferor's death, the TOD deed becomes effective in transferring the underlying property to the beneficiary – if the transferor owned the property at the time of his or her death. However, for the beneficiary to take title to the real estate, the beneficiary must survive the transferor by at least 120 hours, unless the deed provides for a different term. If these conditions are satisfied, the beneficiary will take the property subject to all conveyances, encumbrances, assignments, contracts, mortgages, liens, and other interests to which the property is subject at the transferor's death. The beneficiary must then file the transferor's death certificate with the Register of Deeds to document the transfer of title.

Growing Crops

For farm land, the Act allows the owner to include a conveyance of any growing crops to the beneficiary or another third party. Absent specific language to the contrary, any growing crops would be included in the estate of the transferor.

TOD Deed – Impact upon Creditors

The TOD deed has no effect on the rights of secured or unsecured creditors of the transferor, regardless of whether you have notice of the deed. The beneficiary of a TOD deed would take the property subject to any properly recorded deed of trust or other secured debt. Also, although the property does not pass through probate, the beneficiary would still be liable for estate administration expenses including inheritance taxes and creditor's claims. For unsecured creditors, the Act allows them the same ability to reach the property as those non-probate assets owned by the decedent's revocable trust.

Although TOD deeds avoid probate, many of the same features and concerns of traditional estate planning and administration exist with this nonprobate procedure. In many respects TOD deeds simplify the process of transferring real estate upon death, but there are still traps that may interfere with a transferor's actual intent. Like any other legal document, banks and bank customers using TOD deeds should be familiar with the laws for using such instruments. ■

Daniel P. Fischer
Douglas D. Murray

FDIC/OCC Issue Proposed Guidance on Deposit Advance Products

On April 24, 2013, the CFPB released a white paper of initial data findings regarding a study the CFPB conducted into payday loans and deposit advance products.[2] Based on its findings, the CFPB concluded that these products were harmful to consumers because they are provided without adequate analysis into an individual's ability to pay and are used by those individuals for extended periods of time, locking consumers into a cycle of debt. On the heels of this report, the FDIC and OCC each issued identical proposed guidance for their respective regulated institutions regarding the continued and future use of deposit advance products.[3] The proposed guidance supplements existing payday loan and subprime lending guidance from both agencies and supplants the OCC's previous proposed guidance on advance deposits issued on June 8, 2011.

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2 CFPB, White Paper on Payday Loans and Deposit Advance Products, available at http://www.consumerfinance.gov/reports/white-paper-on-payday-loans-and-deposit-advance-products/

3 FDIC, Proposed Guidance on Deposit Advance Products, available at http://www.fdic.gov/news/news/press/2013/pr13031a.pdf; OCC, Proposed Guidance on Deposit Advance Products, available at http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-11a.pdf

A deposit advance product is a small-dollar, short-term loan that a bank makes available to a customer whose deposit account reflects recurring direct deposits. The customer is allowed to take out a loan, which is to be repaid from the proceeds of the next direct deposit. These loans resemble payday loans insofar as they feature high fees, are repaid in a lump sum in advance of the customer's other bills and often do not closely scrutinize a customer's ability to repay the loan and meet other necessary financial obligations.

The Agencies proposed guidance states that their examiners will focus on compliance with applicable consumer protection statutes and potential safety and soundness issues. They also will examine credit quality, including a bank's underwriting and credit administration policies and practices. Additional considerations and focuses for the Agencies include: over-reliance on fee income; the adequacy of the allowance for loan and lease losses; compliance with federal law and regulations; and the oversight of third-parties.

With regard to specific requirements in the proposed guidance, banks should first be aware that their underwriting and eligibility criteria for deposit advance products should be the same as the criteria used for other bank loans. Further, such criteria should ensure that advance deposit credit can be repaid while allowing the consumer to meet typical recurring and other necessary expenses (housing, transportation, healthcare) as well as other outstanding debt obligations. The Agencies state that a consumer should be able to meet such necessary expenses and other obligations without the need to borrow repeatedly.

These loans resemble payday loans insofar as they feature high fees, are repaid in a lump sum in advance of the customer's other bills and often do not closely scrutinize customer's ability to repay the loan and meet other necessary financial obligations.

With regard to other factors for consumer eligibility, banks should ensure that consumes utilizing advance deposit products have patronized the bank long enough to evaluate their advance deposit eligibility – at least 6-months – and that the consumer does not possess any delinquent or adversely classified credit. Further, banks should analyze a consumer's ability to repay the advance deposit. Such analysis includes examining the consumer's income level, inflows (excluding lines of credit), outflows, and the consumer's net surplus or deficit after the preceding 6-month period.

After a deposit advance is extended, the bank is obligated to monitor the consumer's continued eligibility at least once every 6-months and identify risks negatively affecting such eligibility. Such risks include the repetitive use of the deposit advance product, the overextension of total credit and overdrafts. Further, prior deposit advances should be fully repaid before another advance is made and a "cooling off" period of one billing cycle should be observed prior to all subsequent advances.

Additional considerations banks should be aware of in light of the Agencies' proposed guidance include monitoring any undue reliance on fees generated by deposit advances, maintaining appropriate management oversight, including periodic reports to a bank's board of directors or a designated committee, and oversight of third-party relationships to ensure those third-parties comply in their own right. Banks should also be aware that any loans exhibiting subprime characteristics are considered high risk and will require greater levels of capital.

In sum, the FDIC and OCC proposed guidance places a number of new obligations and considerations on banks with regard to the offering and monitoring of deposit advance products. Adherence to these obligations and considerations should be reflected in a bank's written policies and procedures with proper oversight and monitoring by the bank to ensure compliance. ■

Eli A. Rosenberg

Upcoming Speaking Engagements

On Thursday, June 27, 2013 Mr. Maher will chair a panel discussion, "Maintaining a Profitable Program in a Moving Regulatory Landscape," at the Power of Prepaid Conference in National Harbor, Maryland.

He will also speak on a panel on "UDAP/UDAAP, Disclosures, and Marketing: Regulatory and Compliance Considerations for New Payment Models" at the American Conference Institute's 6th National Forum on Emerging Payment Systems on September 18, 2013, in Washington, DC.

Mr. Maher will co-chair the American Conference Institute's 8th National Prepaid Card Compliance Forum October 3-4, 2013, in San Francisco, CA. ■

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