

Commentary

Acceleration Prepayment Penalty Enforced

by Dan Schechter

In a decision that is both helpful and instructive (from the view point of secured lenders), a California appellate court has enforced a prepayment penalty contained in a promissory note, even though the prepayment was involuntary. [*Biancalana vs. Fleming*, 1996 Westlaw 262116 (Cal.App., 5/17/96).]

Facts: The seller of real property took back a note containing the following prepayment penalty:

If more than 15% above the yearly total principal payments are made during any one calendar year, the payor agrees to pay the additional income tax created by all excessive monies so paid.

After nine years, the purchaser defaulted. The seller accelerated the obligation; the purchaser offered to pay the note in full, but the seller demanded payment of the additional income tax liability that would result from the prepayment. The purchaser refused, and litigation ensued. The trial court held for the seller, as did the appellate court.

The purchaser first argued that the phrase "additional income tax" was ambiguous, but the court held that it was not. The purchaser next argued that since he could have paid the obligation in full over seven years (at 15% per year), he could not be penalized for paying it in full after nine years. The court held, however, that the purpose of the clause was to avoid a large tax obligation in any single year. The purchaser also argued that since the seller could have manipulated his tax affairs to the detriment of the purchaser, the clause was fatally uncertain, but the court held that it was, at most, a question of interpretation.

Most significantly, the purchaser argued that the prepayment penalty could not apply when the prepayment results from acceleration, rather than a voluntary prepayment. Distinguishing away earlier, seemingly inconsistent cases, the court held that the clause was not limited to voluntary prepayments. The court also noted that to adopt the purchaser's narrow reading of the clause would permit him to escape its effect by defaulting, rather than by prepaying.

COMMENT: This is a very expansive (and expensive!) reading of the prepayment clause and the other quoted language in the note. It is gratifying that the court enforced the clause so vigorously, but I don't think that this case was as clear-cut as the court seemed to think.

In an excess of caution, perhaps the note should have provided as follows: "This prepayment penalty will apply whether the prepayment is voluntary or not." I have been informed that most form agreements contain comparable language, but some do not.

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