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Some Thoughts on Lockouts and Default Prepayment

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Many loan transactions contain what is known as a "lockout" period – that is, a period subsequent to closing where the prepayment of a loan is prohibited. This provision is a "bargained-for" economic term upon which a lender is relying in pricing its loan. A lockout period may be a strict lockout with no right of prepayment or it may allow prepayment with the payment of a prepayment fee or provision of some form of "yield maintenance." In all events, this fee, premium or yield maintenance is an agreed-upon economic term upon which a lender is relying should it not receive the economic "deal" it bargained for in the form of contracted-for interest payable over the complete term of the lockout period.

In securitized, fixed rate financings, the loan is not prepayable at all and is, in effect, "locked out" from prepayment until the last few months of the loan to allow for a refinancing. In this context, a borrower is given the ability to defease its loan but not prepay the loan. A defeasance is a mechanism whereby a borrower replaces the collateral of the mortgaged property and its cash flow with a package of treasury securities tailored to create a cash flow which will yield the interest payments which are required under the mortgage loan for the remainder of the term of the mortgage loan *and* to provide for the principal repayment upon maturity of the mortgage loan.

As a result of these restrictions, a borrower would not have any right to prepay its loan during any such lockout period. If the lockout period is a complete restriction, then any attempt to prepay the loan could be rejected by the lender, and the lender would not have any obligation to accept such tender of prepayment. Notwithstanding the foregoing, one inalienable right a borrower always has is what is known as its right of redemption. Since when a borrower enters into a mortgage financing it is either (a) granting a mortgage on its property whereby the lender has a lien on the property as collateral security for repayment of the loan (these jurisdictions are commonly referred to as lien "theory" states since there is a lien on the property) or (b) granting a deed of trust whereby the borrower's property is technically conveyed to a trustee in trust for the benefit of a beneficiary (the lender) as collateral security for repayment of the loan (these jurisdictions are commonly referred to as "title theory" states since the title to the property is technically conveyed), when the loan is repaid, the borrower is exercising its right to redeem its property. This right allows the borrower to "redeem" its property (that is, obtain the release of the mortgage lien upon its property or "reconveyance" of its property) upon payment to the lender of all outstanding amounts. Since real property is "unique" in the eyes of the law, courts are reluctant to allow a lender to potentially reap a windfall when a borrower defaults a mortgage loan by taking the borrower's property. Courts will protect a borrower's right to redeem its property and will endeavor to allow a borrower in all events to pay back its lender in full and obtain a release of the lien on the mortgage on its property. Courts allow this after a default, after the commencement of a foreclosure, after months or years of litigation and in most jurisdictions at any time *prior* to the *completion* of the foreclosure auction. So the risk to a lender is that, simply put, if a borrower were to default its loan, it then can "prepay" the loan by tendering all amounts due under the loan to the lender and receive a discharge or satisfaction of its mortgage lien. A borrower always has the right to pay off its loan by paying the lender all amounts owed prior to the completion of the foreclosure auction. Consequently, a borrower could circumvent a prepayment prohibition by defaulting its loan and then tendering full payment.

In order to prevent or deter this "default prepayment," many loan documents contain a provision that in this circumstance there is a significant premium of, say, 5% or even 10% of the principal amount of the loan that is payable in connection with any payoff of the loan tendered subsequent to a default. While these provisions are negotiated, in the limited circumstance described, they are generally agreed upon and do function as a deterrent. As long as these amounts are not viewed as a penalty, a court should uphold these provisions as permissible and, in such a circumstance, a borrower's tender of payment to redeem would be required to include this additional sum in order for a lender to be required to accept such payment in satisfaction of the outstanding debt. At a minimum, these provisions should give any borrower pause to try to circumvent its agreed-upon economic transaction.