CLIENT ALERT

Trouble Ahead: Seventh Circuit Court Reviewing Yield Maintenance Provisions

Aug.15.2007

Earlier this year, the U.S. Court of Appeals for the Seventh Circuit heard argument on an appeal of a decision by the U.S. District Court for the Northern District of Illinois, which struck a standard yield maintenance clause as an unenforceable penalty. The pending case is a foreboding example of the litigation likely to arise during the next round of bankruptcies and restructurings.

In *River East Plaza LLC v. The Variable Annuity Life Company*, No. 03 C 4354, 2006 WL 2787482 (N.D. Ill. Sept. 22, 2006), the District Court below determined that a prepayment fee provision providing for yield maintenance for the duration of the loan term was an unenforceable penalty under Illinois liquidated damages law. The prepayment formula at issue reduced to present value all unpaid installments of principal and interest by reference to the yield to maturity on a U.S. Treasury bond or note having a maturity date closest to the maturity date of the loan. The District Court observed that a prepayment provision should represent the present value of the lost interest on the remaining principal over the term of the loan if the lender reinvested the principal in a comparable investment. The court went on to suggest that the Treasury rate will always be lower than the prevailing rate on a commercial real estate loan because of the difference in risk. *But see, In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122 (Bankr. E.D.N.Y. 2002) (citing Second Circuit cases enforcing yield maintenance provisions under New York law, and observing that if interest rates rise after a loan was made, such that Treasury yields equal or exceeded the interest rate on the loan, the premium would be zero).

Certain peculiar facts likely influenced the District Court's decision in *River East*. For example, the prepayment provision was not subject to negotiation. In addition, the lender did not attempt to explain away prior testimony of an employee of the lender's parent company, who stated that the prepayment provision was "very, very punitive." The lender also did not provide any evidence of actual damages and elected not to segregate the prepaid funds for purposes of determining the actual return on reinvestment. In the end, the court determined that the prepayment provision based on the Treasury rate was not reasonable and bore no relationship to damages that might have been sustained by the lender. Although the District Court enforced the alternate prepayment fee of one percent, it ruled that the borrower was entitled to a multi-million dollar refund.

Although the *River East* litigation may be viewed in isolation as a dispute concerning the enforceability of a prepayment provision, the case also may be viewed as an example of the kind of litigation likely to become more prevalent as the number of corporate bankruptcies and restructurings increases. The high level of liquidity in the credit and distressed debt markets over the last several years has resulted in a variety of loan products containing new and creative provisions, which as yet are largely untested.

Several recent bankruptcy cases suggest that the terms of pre-bankruptcy financing arrangements will be aggressively litigated. For example, in *Meridian Automotive*, Case No. 05-11168 (Bankr. D. Del. filed April. 26, 2005), parties litigated over the enforceability of inter-creditor second lien waivers. In *Aerosol Packaging, LLC*, Case No. 06-67096 (Bankr. N.D. Ga. filed June 21, 2006), the court enforced a pre-bankruptcy assignment of voting rights from a second lien lender to the first lien holder. *See also*, *Wilmington Trust Co. v. Solutia, Inc. (In re Solutia, Inc.)*, No. 05-01843, 2007 WL 1302609 (Bankr. S.D.N.Y. May 1, 2007)

(Beatty, J.) (court finding, after a trial, that noteholders were properly de-securitized under the terms of their indenture by a new loan agreement ten weeks before the bankruptcy filing).

Recent events, such as the subprime mortgage crisis and the failure of a few leveraged hedge funds, signify the approach of the next phase of the business cycle. Before the business cycle fully turns, lenders, servicers and distressed debt investors should take note of cases following *River East* and prepare for the litigation road ahead.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.