A man borrowed $500,000 from a bank, securing the loan with a mortgage on a commercial building he owned.

The mortgage provided as follows: "No prepayment may be made on this loan during the first two years after the date of this mortgage. Thereafter, prepayment may be made in any amount at any time but only if accompanied by a prepayment fee of 5% of the amount prepaid."

One year later, the man received an unexpected cash gift of $1 million and wished to pay off the $495,000 principal balance still owed on the loan. Concerned that the bank might refuse prepayment—despite a rise in market interest rates in the year since the loan was made—or at least insist on the 5% prepayment fee, the man consulted an attorney concerning the enforceability of the above-quoted clause.

There is no applicable statute.

What is the attorney likely to say?

A. The entire clause is unenforceable, because it violates a public policy favoring the prompt and early repayment of debt.

B. The entire clause is unenforceable, because the rise in interest rates will allow the bank to reloan the funds without loss.

C. The two-year prepayment prohibition and the prepayment fee provision are both valid and enforceable.

D. The two-year prepayment prohibition is unenforceable, but the prepayment fee provision is enforceable.

Explanation:

Right to prepay mortgage

Common law	Prepayment *barred* unless mortgage documents provide otherwise
Majority rule	Prepayment *allowed* unless mortgage documents provide otherwise

Under the common law "perfect tender in time" rule, a mortgagor (debtor) has no right to prepay a mortgage debt unless the mortgage documents provide otherwise. However, the prevailing **modern trend** reverses this presumption and **allows prepayment *unless*** the **mortgage documents provide otherwise**.

Prepayment prohibitions or penalties contained in a mortgage are generally **valid and enforceable**.* They do not violate public policy because they serve the beneficial purpose of:

allowing the mortgagee to maintain the financial yield intended under the mortgage agreement *and*

compensating the mortgagee for any losses suffered because of a prepayment **(Choice A)**.

As a result, the two-year prepayment prohibition and prepayment fee provision in the man's mortgage are valid and enforceable, even if the bank could reloan the funds to another without loss **(Choices B & D)**.

*Roughly half of all states prohibit or restrict prepayment penalties on mortgaged residential property (eg, by limiting the penalty rate or time in which the penalty can be imposed).

Educational objective:

A debtor has the right to prepay a mortgage debt unless the mortgage provides otherwise. Prepayment prohibitions or penalties in a mortgage are generally valid and enforceable.

References

Restatement (Third) of Property: Mortgages §§ 6.1–6.2 (Am. Law Inst. 1997) (right to prepay mortgage).