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Exit Fees

Collectibility Based on Loan Document Clarity

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It is a generally accepted practice for commercial lenders to incorporate prepayment premiums (or penalties) into loan documents in order to counteract any potential lost interest or other costs resulting from the early payoff of a loan. These prepayment premiums may also be referred to as a "make whole premium." Additionally, it is now common for lenders to provide for an "exit fee" when the loan is paid off. Exit fees, in effect, constitute additional or deferred interest and differ from prepayment premiums in that they are typically due at any time the loan is paid off, even at time of maturity, whereas prepayment premiums are usually only triggered upon prepayment of all or part of the loan.

The applicability and enforceability of prepayment premiums and exit fees has been the subject of recent litigation both in New York and elsewhere, with lenders and borrowers advancing contrary positions based upon their particular reading of the relevant loan documents. In reviewing these cases, it becomes clear that precision of drafting may have avoided the disputes and saved considerable litigation expense to all parties.

'Delta Rault'

The United States District Court for the Eastern District of Louisiana, in *Delta Rault Energy 110 Veterans L.L.C. v. GMAC Commercial Mortgage Corp.*, 2004 U.S. Dist. LEXIS 15136 (E.D. La. Aug. 4, 2004), the court directly confirmed the collectibility of an exit fee payable upon acceleration as an additional loan charge in a short-term mortgage loan where the borrower prepaid the loan in connection with a refinancing. The court rejected the borrower's contention that the exit fee was an unenforceable penalty, viewing the exit fee as additional consideration for the loan.

FINANCING

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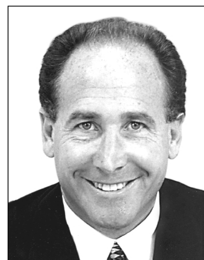
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Delta Rault involved a promissory note containing an exit fee provision requiring a fee equal to 1 percent of the original principal balance of the promissory note due on the date of prepayment or on the date of maturity of the loan. The only exception to the payment of the exit fee would arise if the lender provided permanent financing for the mortgaged property. The borrower contended that the lender did not offer permanent financing at a market rate and that, therefore, the borrower should have the benefit of the exception. The court also rejected this contention, finding that no such obligation existed and that, as sophisticated parties "if such a requirement was intended, the parties could have easily written such a requirement into the Note." Id. at *10.

Contrary results were reached in two New York cases. In *Anthracite Capital, Inc. v. MP-555 West Fifth Mezzanine, LLC*, 2005 U.S. Dist. LEXIS 9179 affirmed 2005 U.S. App. LEXIS 28185 (Dec. 20, 2005), the U.S. District Court for the Southern District of New York refused the lender an award of a "supplemental exit fee" called for in a mezzanine loan financing agreement secured by the loan and in *Citadel Equity Fund Ltd. v. Aquila, Inc.*, 371 F. Supp. 2d 510 (May 18, 2005), the same court denied the lender's request for payment of a "make whole premium."

'Anthracite'

In *Anthracite*, the court denied the lender the right to collect an exit fee that would become due upon a sale of certain real estate underlying a mezzanine loan to the owners of the properties. The mezzanine loan agreement provided for a "supplemental exit fee" upon the sale of the properties. The case turned on whether a debt restructuring by the borrower constituted a sale of the properties. Plaintiff Anthracite, a publicly traded REIT, owned a portion of a $61.1 million mezzanine loan that was made to the Maguire Organization, and personally guaranteed by defendant Robert Maguire.

Maguire, in an effort to reduce personal guarantees on Maguire Organization debt, implemented a complex restructuring process involving refinancing debt and offering stock to the public through an IPO. In conjunction with the IPO, Maguire planned to refinance portions of

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debt owed by the Maguire Organization, which involved prepayment of several loan obligations, including the mezzanine loan and the undertaking of new loans. Additionally, the restructuring involved the creation of two new entities for the purpose of taking title to the properties which originally were the subject of the mezzanine loan.

As a result of the transfer of title, Anthracite contended that the exit fee was triggered and demanded payment. Maguire refused and Anthracite brought suit. After joinder of issue, both parties moved for summary judgment. Granting defendants' motion, the court concluded that the exit fee was not due because no "sale" had occurred, as envisioned in the loan documents.

The court based its decision on the language of the loan documents which, in the court's opinion, tied the exit fee to the actual sale of the property, not a transfer of interests. The court stated that the "Loan Agreement unambiguously stipulates that the Supplemental Exit Fee is payable upon a sale of the 'Property,' not a sale of interest in the property." *Anthracite* at *25.

Because the loan documents did not define the term "sale," the court used the "ordinary meaning of the term" which was "the transfer of property or title for money or consideration." Id. at *20. Additionally, the court noted that the exit fee provision in the loan documents itself required some form of payment or other consideration for the sale of the property. Anthracite was unable to offer any evidence to show consideration. The court concluded that "the payment of a consideration to change the identity of the person with a controlling interest in the entity holding title to the [properties] is not the payment of consideration contemplated by [the exit fee provision]." Id. at *26.

Anthracite also asserted a claim for the breach of the covenant of good faith and fair dealing, which is often asserted in lending litigation (more often by borrowers) and is worth noting. The court observed that:

"Ultimately, a claim based on the implied covenant of good faith and fair dealing 'may not be used as a substitute for a nonviable claim of breach of contract.' *Sheth v. N.Y. Life Ins. Co.*, 273 A.D.2d 72, 709 N.Y.S.2d 74, 75 (1st Dep't 2000)."

The court then concluded that the covenant of good faith and fair dealing could not be invoked because nothing in the loan documents required the borrower to pay the exit fee and that to imply such a requirement was inconsistent with the loan documents.

'Citadel'

Citadel Equity Fund Ltd. v. Aquila, Inc., supra, involved a lender's attempt to recover a "make whole premium", in lieu of "a mandatory prepayment" under the credit agreement.

> *In reviewing some recent cases, it becomes clear that precision of drafting may have avoided the disputes and saved considerable litigation expenses to the parties.*

Pursuant to the agreement, the borrower (Aquila) was required to make a mandatory prepayment together with a premium of 2 percent of the aggregate principal amount of various loans upon certain triggering events. The credit agreement also contained a provision that governed Aquila's obligations in the event that it opted to voluntarily prepay its loan obligations. This provision, involving a make whole premium, required a premium upon payment of the loan relating to the borrower's debt obligations with preexisting creditors, not the loans subject to the credit agreement.

As part of an overall program of financing, Aquila engaged in securities offerings and retired certain long-term debt and other liabilities, but it did not retire or defease certain senior debt that, if not retired or defeased, would trigger the mandatory prepayment. As a result, Aquila advised its lender (Citadel) that the mandatory prepayment with the 2 percent premium would be made. Citadel countered that the prepayment was voluntary and that the make whole premium constituting an additional $27,300,000 would be due. In order to obtain the release of approximately $1 billion in collateral, Aquila deposited the amount claimed by Citadel in escrow. This action ensued.

One of the issues before the court was whether Aquila had defeased the senior debt. Finding no express definition of the term "defease" in the credit agreement, the court consulted dictionaries and treatises for the accepted meaning of the term. The court then concluded that, in the context of the credit agreement, defeasance required either the termination of Aquila's obligation to the senior note holders or the creation of a trust for the payment of the senior debt. Having failed to defease the senior debt, the court ruled that Aquila was then obligated to make the mandatory prepayment, thereby eliminating the requirement of the make whole premium.

Conclusion

In order to eliminate any question regarding the applicability of an exit fee, we recommend a simple straightforward clause which provides that: (a) the fee is an amount equal to a fixed percent of any amount prepaid, (b) the fee is due in all events and under all circumstances upon full or partial prepayment of the loan, or repayment upon maturity, (c) the lender is not obligated to accept any prepayment or repayment unless the borrower pays the exit fee, and (d) the lender shall have no obligation to release any loan documents until the entire exit fee is paid. Finally, the borrower should acknowledge that the exit fee constitutes additional consideration for the loan. In certain circumstances an exception to the payment of the exit fee may be provided where the borrower repays the loan prior to the maturity date with the proceeds of a new loan from the lender.

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