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Imposition of Penalty Must Be Caused by Prepayment.

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PAYMENT—Prepayment Penalties—Imposition of Penalty Must be Caused by Prepayment

Goldman v. First Federal Savings & Loan Association,
518 F.2d 1247 (7th Cir. 1975).

In March 1966, Michael and Judith Goldman secured a home mortgage loan from the First Federal Savings & Loan Association of Wilmette, Illinois. The promissory note provided for equal installment payments payable on the fifth day of each month. The interest paid under each installment was for the use of the principal in the month in which payment was made. On June 5, 1973, the Goldmans made their regular monthly payment; on June 21, they retired the loan by paying First Federal the entire balance due. Upon receipt of a $25 fee, First Federal cancelled the note and released the mortgage.

The Goldmans noted that the June 5 installment included an interest payment for an entire month, and filed a class action seeking a refund of the interest paid for the period of June 22 through July 4, 1973. They contended that the retention of that interest was a prepayment penalty, and therefore violated a regulation of the Federal Home Loan Bank Board.[1] The district court found that First Federal had exacted such a penalty, and held for the Goldmans.[2] First Federal appealed to the Court of Appeals for the Seventh Circuit. Held—*Reversed.* Where contract terms by their nature result in the exaction of some unearned interest when the final payment is made, retention of such unearned interest following a borrower's voluntary early retirement of a loan does not constitute a prepayment penalty. A true prepayment penalty is exacted only when the imposition of the charge is caused by prepayment.[3]

"Prepayment" of a loan is its payment in advance of the contract maturity date.[4] At common law, it was not favored; a creditor could not be compelled to accept payment before it was due.[5] Installments of a debt payable periodically at fixed dates could not be paid before their due dates

1. 12 C.F.R. § 545.6-12(b) (1975).
2. Goldman v. First Fed. Sav. & Loan Ass'n, 377 F. Supp. 883 (N.D. Ill. 1974), *rev'd*, 518 F.2d 1247 (7th Cir. 1975).
3. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1252 (7th Cir. 1975).
4. *See* Chapp v. Peterson, 397 P.2d 5, 8 (Nev. 1964); Feldman v. King's Highway Sav. Bank, 102 N.Y.S.2d 306, 307 (App. Div. 1951) (on loan under whose terms final payment was due in April 1959, payment of entire balance of debt in March 1950 held a prepayment); Peryer v. Pennock, 115 A. 105 (Vt. 1921).
5. Hanson v. Fox, 99 P. 489, 490 (Cal. 1909); Dugan v. Grzybowski, 332 A.2d 97, 99 (Conn. 1973); Fowler v. Courtemanche, 274 P.2d 258, 270 (Ore. 1954); *see* Westminster Inv. Corp. v. Equitable Assur. Soc., 443 F.2d 653, 657 n.5 (D.C. Cir. 1970).

without the creditor's consent to such prepayment.[6] This principle is the corollary of the rule that a debtor cannot be compelled to tender payment before it is due.[7]

The creditor could, of course, agree to the debtor's request to prepay, and by doing so, create a new, separate contract, a contract providing for the premature termination of the debt.[8] The consideration for this new contract was a payment made by the debtor in exchange for his creditor's release of the right to collect that interest which the debt would have earned had the prepayment not been made.[9] The payment made by the borrower was called a "prepayment penalty" or a "prepayment charge," that is, a charge the creditor imposed on the debtor for the privilege of prematurely retiring an indebtedness in part or in whole.[10]

Despite numerous decisions upholding their legality, prepayment penalties have been regarded as undesirable by some courts.[11] It has been asserted that though a creditor has the right to impose prepayment penalties, such conduct is "not liberal or praiseworthy."[12] Moreover, one court has indicated that prepayment penalties are appropriate only in situations in which the note is intended to secure a regular investment income to the lender, and not where the note is given as security for the timely repayment of the loan, since the object of the latter is best fulfilled by allowing prepayment without penalty.[13] Because of such considerations, several regulations and statutes,

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6. McCarty v. Mellinkoff, 4 P.2d 595, 596 (Cal. Dist. Ct. App. 1931); Atlantic Life Ins. Co. v. Wolf, 54 A.2d 641, 643 (D.C. Mun. Ct. App. 1947); Ebersole v. Redding, 22 Ind. 232 (1864).

7. Hanson v. Fox, 99 P. 489, 490 (Cal. 1909) (rights of parties are determined by their contract, and neither can put the other in default by attempting to vary terms).

8. *E.g.*, McCarty v. Mellinkoff, 4 P.2d 595, 596 (Cal. Dist. Ct. App. 1931); Feldman v. King's Highway Sav. Bank, 102 N.Y.S.2d 306, 307 (App. Div. 1951); Reichwein v. Kirshenbaum, 201 A.2d 918, 920 (R.I. 1964).

9. McCarty v. Mellinkoff, 4 P.2d 595, 596 (Cal. Dist. Ct. App. 1931); *see* Shalit v. Investors' Sav. & Loan Ass'n, 244 A.2d 151, 153 (N.J. Super. 1968); Smithwick v. Whitley, 67 S.E. 914, 915 (N.C. 1910); Reichwein v. Kirshenbaum, 201 A.2d 918, 920 (R.I. 1964). Since the money paid by the borrower is consideration and not interest, it has been repeatedly held that a transaction otherwise free from usury is not rendered usurious by the collection of such charges. *E.g.*, Shalit v. Investors' Sav. & Loan Ass'n, 244 A.2d 151, 153 (N.J. Super. 1968); Bell Bakeries v. Jefferson Standard Ins. Co., 96 S.E.2d 408, 415 (N.C. 1957); Reichwein v. Kirshenbaum, 201 A.2d 918, 920 (R.I. 1964). *But see* General Am. Life Ins. Co. v. Commissioner, 25 T.C. 1265, 1267 (1956); Rev. Rul. 57-198, 1957-1 Cum. Bull. 94 (for federal tax purposes prepayment penalties are interest).

10. *See, e.g.*, Feldman v. King's Highway Sav. Bank, 102 N.Y.S.2d 306, 307 (App. Div. 1951); Reichwein v. Kirshenbaum, 201 A.2d 918, 920 (R.I. 1964); Gulf Coast Inv. Corp. v. Pritchard, 438 S.W.2d 658, 661 (Tex. Civ. App.—Dallas 1969, writ ref'd n.r.e.).

11. *See* Associated Schools, Inc. v. Dade County, 209 So. 2d 489 (Fla. Dist. Ct. App. 1968); Smithwick v. Whitley, 67 S.E. 914, 915 (N.C. 1910).

12. Smithwick v. Whitley, 67 S.E. 914, 915 (N.C. 1910); Barclay v. Walmsley, 102 Eng. Rep. 750, 751 (K.B. 1803).

13. *See* Dugan v. Grzybowski, 332 A.2d 97, 99 n.2 (Conn. 1973).

both state and federal, have been enacted either abolishing or greatly curtailing the use of prepayment penalties.[14]

Prepayment penalties may be imposed in one of two forms. Normally, the creditor exacts a new, additional charge, but it is also possible that the creditor retain money given to him which he would otherwise be required to restore to the borrower.[15] The latter form is typically imposed by retaining prepaid interest.

Prepaid or advance interest is that taken prior to the expiration of the proportionate part of the entire loan that is represented by the amount of interest taken.[16] It is a legal and valid contractual alternative to the normal situation in which interest is paid only after it has accrued.[17] If the interest is to be paid in advance, the period for which prepayment is made may be varied according to the parties' wishes. Interest due during the full term of the loan may be exacted at the time the loan is made.[18] Alternatively, the parties may agree merely to exact interest in advance of given periods in the term of the loan.[19]

In *Goldman v. First Federal Savings & Loan Ass'n*,[20] the issue which faced the Court of Appeals for the Seventh Circuit was whether prepayment of a loan had converted prepaid interest into a prepayment penalty. There was no question that the system of payments set out in the parties' contract

14. *See, e.g.*, 12 C.F.R. § 226.8(b)(6) (1975) (creditor must disclose any prepayment penalties that may be imposed, and explain how penalty will be computed); 12 C.F.R. § 545.6-12(b) (1975) (savings and loan associations may not charge prepayment penalties on home mortgage loans absent express agreement by parties to the contrary); UNIFORM CONSUMER CREDIT CODE §§ 2.209, 3.209 (buyer may prepay in full without penalty).

15. Some courts have held that prepayment penalties represent a new additional charge. Hamilton v. Kentucky Title Sav. Bank & Trust Co., 167 S.W. 898, 899 (Ky. Ct. App. 1914); Feldman v. King's Highway Sav. Bank, 102 N.Y.S.2d 306, 307 (App. Div. 1951); Redmond v. Ninth Fed. Sav. & Loan Ass'n, 147 N.Y.S.2d 702, 703 (Sup. Ct. 1955). An example of the latter class, retention of money which should be restored to the borrower, is found in Scott v. Liberty Fin. Co., 380 F. Supp. 475 (D.Neb. 1974), where the court held that the lender must disclose the existence of a prepayment penalty under 12 C.F.R. § 226.8(b)(6) (1975).

16. Annot., 57 A.L.R.2d 630, 633 (1958). Examples of the exaction of advance interest are found in the following cases: Lustgarten v. First Fed. Sav. & Loan Ass'n, 191 N.E.2d 434, 436 (Ill. Ct. App. 1963); Bramblett v. Deposit Bank, 92 S.W. 283, 284 (Ky. Ct. App. 1906).

17. *E.g.*, Fowler v. Equitable Trust Co., 141 U.S. 384, 399-400 (1891); Owens v. Graetzel, 126 A. 224, 227 (Md. Ct. App. 1924); Johnson v. Groce, 179 S.E. 39, 40 (S.C. 1935).

18. This practice is termed "discounting." *E.g.*, Fleckner v. Bank, 21 U.S. (8 Wheat.) 338, 350-51 (1823); Youngblood v. Birmingham Trust & Sav. Co., 12 So. 579 (Ala. 1892).

19. Lustgarten v. First Fed. Sav. & Loan Ass'n, 191 N.E.2d 434, 436 (Ill. Ct. App. 1963) (interest payable in advance monthly); Rose v. Munford, 54 N.W. 129, 130 (Neb. 1893) (interest paid in advance annually on long-term loan).

20. 518 F.2d 1247 (7th Cir. 1975).

constituted the advance payment of interest under Illinois law,[21] nor was there any question that the Goldmans had paid interest for the entire month of June. The problem was that they had used the principal for only the first 21 days of the month, and that First Federal had refused to return the pro rata portion of the June installment payment attributable to the last nine days.[22] This non-refunded portion of the June interest payment was characterized by the Goldmans and the district court as unearned or usurious interest, and since it had accrued to the defendant at the time of prepayment, as a prepayment penalty.[23]

The problem with this conclusion, however, is that it incorporates a fallacy. Assuming that the retention of the interest constitutes some type of penalty, it does not follow from its appearance at the time of prepayment that it is a prepayment penalty. The Goldmans were not aware of the penalty until they prepaid, but such a temporal connection between the two events does not establish a causal one. It is entirely possible that the exaction of a penalty may coincide with prepayment and yet not be caused by it.

This principle, temporal but not causal connection, is readily demonstrated by the Goldmans' payment of the deed release fee at the time of prepayment. This was a $25 charge given to First Federal for the clerical and administrative expenses of cancelling the note and the mortgage.[24] This fee was paid, of course, because the final payment had been made. It is insignificant that the final payment was also a prepayment; the fee would have been required upon final payment irrespective of whether the note was retired early or at maturity. Even though this fee was paid at the time of prepayment, it was not a "prepayment charge," for although the fee was incurred at the time of prepayment, it was not incurred because of prepayment.[25]

The exaction of "unearned" or "usurious" interest at the time of prepayment is analogous. Under the terms of the loan contract, the Goldmans

21. Joliet Fed. Sav. & Loan Ass'n v. Bloomington Loan Co., 265 N.E.2d 400, 403 (Ill. Ct. App. 1970) (system of payments does not violate public policy); Lustgarten v. First Fed. Sav. & Loan Ass'n, 191 N.E.2d 434, 436 (Ill. Ct. App. 1963) (constituted advance, not accrued, interest).

22. The Goldmans sued for refund on the 13 day period, June 22 through July 4. This was incorrect since under the terms of the loan, interest accrued on the first day of each month, at the rate of one-twelfth of the annual rate calculated upon the unpaid balance of the loan as of the last day of the preceding month. Interest was paid from the first of one month to the first of the next month, and not from the fifth to the fifth. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1250 n.5 (7th Cir. 1975).

23. The district court held the interest was unearned because it was interest for a period of time during which no loan balance was outstanding, and held it to be usurious because it raised the interest rate for the month of June over the rate provided in the note. Goldman v. First Fed. Sav. & Loan Ass'n, 377 F. Supp. 883, 886 (N.D. Ill. 1974), *rev'd*, 518 F.2d 1247 (7th Cir. 1975); *see* Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1251 (7th Cir. 1975).

24. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1252 (7th Cir. 1975).

25. *Id.* at 1252.

would make their final payment on the fifth day of the month. That payment would include interest for the balance of the month, yet by definition, since the payment is the final one, the note would have been paid in its entirety, and the interest attributable to the period of the sixth day through the 30th day would not be earned. Thus, unearned or usurious interest would be included in the final payment, even though that final payment was not a prepayment.[26] The penalty would be incurred not because of prepayment, but simply because of final payment. Since there is no causal connection between the penalty and the prepayment, it would be illogical to describe it as a prepayment penalty.

To insure that no such unsound reasoning is used in determining whether a charge exacted from a debtor is a prepayment penalty, the Court of Appeals for the Seventh Circuit set out a test in *Goldman* which establishes the primacy of causal connection. To be classified as a prepayment penalty, the charge imposed at the time of prepayment must be one that would not have been imposed but for the prepayment. In each case, the court must ask what caused the penalty to be imposed.[27] In *Goldman*, the imposition of the penalty did not result from prepayment; rather, it was an inherent feature of the contract terms. It follows, therefore, that although First Federal's retention of the unearned interest may have been some type of penalty it was not a prepayment penalty.

It must be emphasized that it is the cause of the imposition, and not the form of the penalty, that is determinative under the *Goldman* test.[28] For example, the retention of prepaid unearned interest, the penalty imposed upon the Goldmans, may constitute a prepayment penalty, provided the penalty is incurred because of prepayment. In *Scott v. Liberty Finance Co.*[29] it was held that the retention of unearned interest following the early retirement of a discounted loan constituted a prepayment penalty.[30] The *Goldman* test supports that result. The penalty in *Scott* occurred because the note was prepaid; had the note been paid according to the contract schedule there would have been no penalty.[31] It is not significant that the

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26. The Seventh Circuit's illustration clarifies this point:

> Assume that the regular monthly payment on April 5, 1986, would reduce the principal balance to $100. Under the terms of the note, on May 1, 1986, an interest charge of 46 cents (½ of $5.50) would be added to the principal. Then, if on May 5, 1986, the borrower made a final payment of $100.46, that payment would include interest for the balance of May, even though during the period between May 5 and May 31 the note would have been paid in full, and interest attributable to that period would never be earned. Moreover, the retention of the entire 46 cents would create a true interest cost for the first few days in May of well over 5½%.

Id. at 1252.

27. *Id.* at 1252.
28. *Id.* at 1252.
29. 380 F. Supp. 475 (D. Neb. 1974).
30. *Id.* at 479.
31. *See id.* at 481 (appendix C).

penalty itself consists of retained unearned interest as opposed to the exaction of a wholly new, additional charge.[32] If the penalty is imposed because of prepayment, it is a prepayment penalty.

Although *Goldman* held that a purely causal test is to be applied in determining whether a prepayment penalty has been charged, dicta indicated that the court's understanding of the use of the term in the Federal Home Loan Bank Board's regulation is more restricted.[33] Retention of money, as in *Goldman* and *Scott*, was said not to constitute a prepayment penalty under that regulation. Rather, the regulation was said to be aimed exclusively at controlling the practice of exacting an additional charge in exchange for the privilege of prepaying a loan. The court justified this position by asserting that the regulation is concerned with the type of agreement the parties may make.[34] This was not explained, but presumably it means that the regulation is only concerned with prepayment penalties which are anticipated by the parties at the time the contract is made, and not with those, such as First Federal's retention of the unearned interest, which were not foreseen.

Whether such a limitation is correct depends largely upon the intent and purpose of the regulation. Although no court appears to have resolved the question, it seems that the purpose of the regulation is to circumscribe a practice which is deemed onerous and unfair to the borrower.[35] If that is so, then the limitation would appear to be correct. No administrative regulation would be required to protect the borrower whose funds are improperly withheld since the common law remedies of breach of contract and restitution afford ample relief. Regulation is appropriate to the exaction of additional charges, however, since the common law provides no protection from this practice. Manifestly, construction of a restrictive regulation should limit its operation to the evil it seeks to prevent.[36]

The argument in favor of limitation is supported by the scheme of the section of the Code of Federal Regulations in which the regulation appears.[37] Composed of 25 regulations, that section deals with real estate loans, and as *Goldman* indicates, is specifically concerned with the types of loans which are allowable and with their terms.[38] The section seeks to regulate the bargain reached by the borrower and the lender, and as such, is not concerned with events, unforeseen at the time the loan was made, which

32. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1251 (7th Cir. 1975).
33. *Id.* at 1252 n.10.
34. *Id.* at 1252 n.10.
35. *See* Smithwick v. Whitley, 67 S.E. 914, 915 (N.C. 1910); Barclay v. Walmsley, 102 Eng. Rep. 750, 751 (K.B. 1803).
36. *C.f.* United States v. Champlin Ref. Co., 341 U.S. 290, 297 (1951); Tallios v. Tallios, 112 N.E.2d 723, 725 (Ill. Ct. App. 1953).
37. 12 C.F.R. § 545.6 through § 545.6-25 (1975).
38. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1252 n.10 (7th Cir. 1975).

may arise in the course of performance. The retention of unearned interest falls into this latter category. Further, the ceiling the regulation places on the prepayment penalty to which the parties may agree indicates an intent to limit the scope of the regulation to the exaction of additional charges. The regulation does not contemplate withholding funds already paid, but rather permits a charge of up to six months interest on that part of the prepayment which exceeds 20 percent of the original principal amount.[39]

It is possible, however, that the purpose of the regulation is not the control of an undesirable practice, but instead, the encouragement of repaying the loan.[40] If that is true, then the limitation suggested in *Goldman* makes little sense. Both forms of prepayment penalty, exaction of an additional charge and retention of unearned interest, operate to discourage repayment. As the opinion in *Goldman* indicates, both forms are undoubtedly penalties,[41] and to the extent that they penalize the borrower for repaying, they dissuade him from doing so. It would be self-defeating to attempt to encourage repayment by prohibiting one practice which discourages it, yet allowing another to go unchecked.

Any discussion of the Federal Home Loan Bank Board's purpose in issuing the regulation is, however, merely speculative. It is not part of the holding in *Goldman.* The actual holding of the case is that a prepayment penalty is imposed only when the imposition of the penalty is caused by prepayment, and irrespective of the validity of the court's argument for a limited interpretation of the regulation, that holding is sound. By accurately defining the circumstances under which prepayment penalties can arise, *Goldman* prevents a possible abuse of the statutes and regulations which control prepayment penalties. It prevents a party from invoking the sanctions of those laws in situations in which they do not apply. Application of the definition in *Goldman* will insure that other penalties are not mistaken for prepayment penalties. If that is accomplished, the result will be clarification of the true remedies available to a party.

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39. 12 C.F.R. § 545.6-12(b) (1975); *see* Arnoff v. Western Fed. Sav. & Loan Ass'n, 470 P.2d 889, 891 (Colo. Ct. App. 1970).

40. *See* Dugan v. Grzybowski, 332 A.2d 97, 99 n.2 (Conn. 1973) (clause in note which permits prepayment without penalty encourages prepayment).

41. Goldman v. First Fed. Sav. & Loan Ass'n, 518 F.2d 1247, 1251 (7th Cir. 1975).