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Commercial Loan, Residential Collateral – Does My Prepayment Clause Apply?
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Prepayment penalties can come as an unwelcome surprise to homeowners looking to refinance an existing residential mortgage. Standard prepayment penalties in residential mortgages (in jurisdictions that permit these penalties) can be 1 or 2 % of the prepaid loan balance. The homeowner who refinances their $400,000 mortgage may find themselves staring at a $4,000 to $8,000 prepayment penalty on their settlement statement. When it comes time to refinance, which is often paid by the new lender as part of the refinance loan, which in turn leads to higher monthly payments for the homeowner and less equity in the property. To protect the ordinary homeowner from precisely this situation, for the better part of a half century New Jersey's Prepayment Law, N.J.S.A. 46:10B-1 *et seq*., which the legislature enacted in 1968, has generally prohibited lenders from charging prepayment penalties on conventional residential mortgage loans. The express language of Section 2 of the statute provides: "Prepayment of a mortgage loan may be made by or on behalf of a mortgagor at any time without penalty."

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The Appellate Division recently clarified in a published opinion that not all residential mortgages are entitled to protection under the Prepayment Law. Specifically, residential mortgages given as collateral for corporate loans do not fall within the ambit of the statute. In *Lopresti v. Wells Fargo*, 2014 W.L. 1356511 (App.Div. Apr. 8, 2014), the court confronted the situation of a family corporation, Body Max, Inc., which took out a $550,000 business loan in 2002 from First Union Bank (which was subsequently acquired by Wachovia, which in turn was subsequently acquired by Wells Fargo). In the event of a prepayment, the loan documents provided for a penalty of 1% of the unpaid loan balance. To secure Body Max's repayment of the loan, the bank required the company's principals, Salvatore and Margaret Lopresti, to execute a personal guaranty of the company's obligations. The bank then required the Loprestis– husband and wife – to secure their guaranties with a mortgage on their primary residence.

In 2005, Body Max refinanced its loan with Wachovia. Unlike the initial loan documents with First Union, which provided for a flat prepayment penalty, the refinance documents provided for a prepayment penalty tied to national interest rates. This change was significant for this closely-held family business.

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When the Loprestis refinanced Body Max's loan again in 2010 with TD Bank, interest rates were such that the prepayment penalty amounted to more than $48,000 – which translated to 13% of the prepaid principal balance of approximately $368,000. Prior to the refinance with TD Bank, Body Max's commercial loan never went into default, and thus, the Loprestis' individual liability under their respective guaranties, and their residence securing those guaranties, were never "at risk" – or at least the "risk" was only contingent as long as Body Max remained in compliance with the loan.

The Loprestis brought suit against Wells Fargo (which by then had acquired Wachovia) challenging the bank's prepayment penalty under the Prepayment Law, inasmuch as Body Max's loan was secured by the Loprestis' personal guaranty, which in turn was secured by a mortgage on their residence. The trial court and the Appellate Division rejected this argument. Although Section 2 of the Prepayment Law precludes lenders from charging penalties on prepayments on "mortgage loans" made by or on behalf of "mortgagors," the court found that neither the Body Max loan nor the Loprestis met these definitions.

While Section 1 of the Prepayment Law defines "mortgage loan" as a loan secured by an interest in property upon which one or more dwelling units are constructed, the definition also provides that the dwelling unit must be erected "with the proceeds of such loan." Additionally, Section 1's definition of "mortgagor" includes "persons," but specifically excludes "corporations." While the Loprestis' personal residence was indeed put at risk in connection with the Body Max loan, given that any default of that loan would have permitted the bank to pursue relief against the guarantors and the collateral securing their guaranty, the court relied primarily on the definitions of "mortgage loan" and "mortgagor" in the Prepayment Law. Because the Prepayment Law does not apply to corporate mortgagors, and because the purpose of the Body Max loan was to fund the business and not to construct or maintain the Loprestis' residence, the court found that the Prepayment Law did not apply. The court drew support for this conclusion from federal case law holding that the purpose of the Prepayment Law is to protect individual homeowners rather than "sophisticated" commercial mortgagors, along with case law endorsing prepayment penalties in the context of business loans. The court further found persuasive the fact that the Loprestis themselves were never literally exposed to recourse by the bank because Body Max never defaulted on its loan with Wachovia.

While the maxim "equity trumps the law" is a noble ambition, it is not always the reality. The Loprestis decision accurately reflects the law – the Prepayment Law does not protect residential mortgages given as collateral in connection with corporate loans.

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As long as the corporation is the borrower, and the individual guarantors did not utilize the loan proceeds for their own residential purposes, the corporation will be responsible for a prepayment penalty. However, the notion that the effects of these prepayment penalties will not be felt by the individual guarantors who pledged their homes as collateral is untrue. The Lopresti business was a small, closely-held, family business, and in such cases it is commonplace for lenders to require the corporate principals to pledge their personal assets as collateral for business loans, effectively negating the insulation that the corporate form is supposed to provide. In all likelihood, when TD Bank refinanced the Body Max loan, it required the same personal guaranties and individual mortgages as Wachovia. Although, according to the Appellate Division's logic, the refinance loan technically inured to the sole benefit of the corporation, the individual guarantors making up the corporation's ownership absorbed effect of the corporation's prepayment penalty in the form of larger residential mortgages, thereby impacting the marketability of their individual assets.

The legal lesson of Lopresti is that residential mortgages are not protected by the Prepayment Law where the underlying loan is extended to a corporation for non-residential purposes. The practical lesson is that principals of closely held family businesses – the likely guarantors of their companies' obligations – would do well to consult with counsel before undertaking a major loan commitment with the objective of negotiating loan terms that exclude prepayment penalties from their individual guaranties of corporate obligations.

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