

A World Without Cognovits

Increased Risks and Costs to Lenders



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Cognovits, sometimes called confessions of judgment, offer a cost-effective and efficient way for lenders to recoup their losses when a commercial borrower defaults on a loan. Incorporating a cognovit provision in a promissory note, guaranty or other instrument provides many advantages, including accelerating the process and reducing the expenses involved in securing a judgment and collecting the debt. Instead of the lender having to expend the significant time, money and resources to file a lawsuit, a cognovit expedites the entry of judgment, enabling the lender to quickly commence collection efforts. Given the bottleneck in the courts and the unpredictability of pursuing claims through the adversarial process, cognovits represent an efficient, reliable and appropriate method of securing judgments following defaults on commercial loans.

Cognovit critics often argue that a confession of judgment deprives a borrower of its "day in court" and the associated protections of notice and opportunity to be heard. Recently, the Ohio General Assembly introduced a bill that would defeat the primary purpose of cognovit provisions by requiring a lender to provide the borrower with notice of the default and notice of the lender's request for judgment, and grant the borrower the right to a judicial hearing before judgment may be entered against it. This legislation, if adopted, would negatively affect not only the banking industry, but Ohio's economy as well because it would increase the risks and expenses of making commercial loans, and it would create more stringent lending standards, making it more difficult for businesses to qualify for commercial loans.

Ohio's Cognovit Procedure

A confession of judgment is a written admission, signed and executed under oath, by a borrower acknowledging liability for a debt and directing judgment against it in the event of default. When used in loan agreements, these admissions are known as cognovit provisions or cognovit judgments. The cognovit procedure is governed by Ohio Revised Code Section 2323.13, which requires a prominent warning statement to be conspicuously placed on the cognovit instrument stating that by signing the borrower is giving up the right to notice and the opportunity to be heard should it default on the debt. The procedure also requires the borrower to execute a warrant of attorney authorizing the lender's attorney to confess judgment on the borrower's behalf.

Once executed, the cognovit is held by the lender until either the loan is repaid in full or the borrower defaults on payments due under the loan and the lender elects to exercise its remedies. Upon default, the lender submits the confession of judgment and the warrant of attorney to the court, along with a petition listing the borrower's last known address. The court will then immediately enter judgment against the borrower specifying the principal due, interest accrued and costs incurred. Assuming the judgment is properly executed pursuant to Section 2323.13, the lender can then exercise all available legal remedies to recover the debt just as if a full trial had occurred.

Ohio House Bill 291

Earlier this year, the Ohio General Assembly considered a bill designed to alter the procedure applicable to cognovits in Ohio. House Bill 291 (Bill) attempts to make five significant changes to Ohio Revised Code Section 2323.13 that would effectively eliminate cognovits. The Bill would:

- Ban the enforcement of cognovits except in cases of monetary default or the nonpayment of amounts due under the terms of an instrument of indebtedness. As a result, non-monetary defaults, such as the breach of financial or other affirmative covenants in loan agreements, would no longer serve as a basis for the lender to seek entry of a cognovit judgment.¹
- Require the lender to give written notice of the monetary default to the borrower at least 30 days before filing a judgment.
- Give the borrower 30 days to request a hearing to determine whether the borrower is in monetary default, at which time both parties would be allowed to call witnesses and offer evidence.
- Require the court to award the borrower costs, attorneys' fees and consequential damages if the court determines, after the hearing, that the lender has not demonstrated the borrower's monetary default.
- Amend the warning language in cognovits to include the right to 30 days' notice and the opportunity for a hearing challenging the monetary default.

In essence, the Bill would eliminate all of the features of cognovits that streamline the process for securing judgments against borrowers who default on commercial loans – their primary purpose – and make them subject to similar procedures applicable to other legal claims. No longer will a loan agreement allow a lender to appear in court and confess judgment against a defaulting borrower.

Increased Lending Risks & Costs

Any legislative attempt to modify Ohio's cognovit procedure would create

greater risk and uncertainty for commercial lending, and increase transaction costs and the expenses attendant to securing judgment, resulting in a number of detrimental effects on Ohio's banking industry.

Higher Transaction Costs, Fewer Loans

Lenders' inability to secure quick judgments against defaulting borrowers through the existing cognovit procedure would increase transaction costs. The implementation of a notice period will lengthen the process to secure a judgment, leading to higher internal and external costs for lenders. Underwriting standards will need to be modified to take into account the increased risks, and many prospective borrowers will no longer qualify, or they will be subject to greater lending costs and required to furnish credit enhancements. Indeed, lenders may need to obtain other forms of security such as personal guarantees to mitigate lending risks. All of which "could make it more difficult for some borrowers to obtain credit and more than likely make it more costly for borrowers to obtain credit."²

Greater Risk of Dissipation of Assets

A notice period and an opportunity for a hearing will also provide a defaulting borrower time to conceal and transfer assets before the lender is permitted to take steps to preserve them. This problem is particularly acute when the assets in question serve as security for the repayment of the loan. As one opponent to H.B. 291 noted, "in most collection efforts, time is of the essence and the lender cannot afford to give a defaulting debtor a head start."³ Additionally, these modifications will likely cause an increase in adversarial proceedings among lenders and other creditors as they fight over the limited assets of the defaulting borrower. Thus, these delays may benefit other creditors at the direct expense of the lender.

Increased Legal Fees

Any legislation that requires a full evidentiary hearing before entry of judgment against a defaulting borrower will raise legal fees significantly. Permitting a borrower to have a hearing and present witnesses and other evidence will require lawyer involvement. It would also provide a forum for the borrower to assert meritless defenses and spurious claims against

the lender to delay entry of judgment and enforcement and complicate the process, with the intent of driving up the lender's legal fees and other litigation expenses. In contrast, the cognovit process is a much more streamlined, efficient and cost-effective method to secure a judgment that requires only limited lawyer participation.

Conclusion

While it appears that H.B. 291 has lost some of its steam, the threat to Ohio's cognovit statute will continue. To avoid losing a valuable tool for efficiently recovering outstanding debts from defaulting commercial entities, members of the lending community must remain vigilant and oppose any attempts to eliminate cognovits in Ohio.^{..}

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¹ Some would argue that this is unnecessary, as the plain language of Section 2323.13 and Ohio case law interpreting this provision already provide for this result. See O.R.C. 2313(D) ("If you **do not pay on time**, a court judgment may be taken against you without your prior knowledge...") (emphasis added). *Henry Cty. Bank v. Stimmels, Inc.*, 2013-Ohio-1607 (2013) (vacating cognovit judgment because the borrower had not missed any payments).

² Crain's Cleveland Business, "State Bill is a Concern for Banks," (March 7, 2016) at p. 23.

³ Opponent testimony of Patrick Harris, H.B. 291.