



Agreeing in Advance to Lose? Legal Considerations in Regulating Confessions of Judgment

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UPDATE 6/13/19: Since the initial publication of this Sidebar, multiple governmental entities have expressed interest in examining confessions of judgment. First, the House Committee on Small Business has [scheduled a hearing](#) to explore “the legalities of the practice, its use, and impact on small business borrowers.” As of the date of this update, the hearing is scheduled for [Wednesday June 26, 2019, at 11:30 AM, in Rayburn 2360](#).

Secondly, the Commissioner of the Federal Trade Commission (FTC) and the Director of the FTC’s Bureau of Consumer Protection (Director) [indicated last month](#) that the FTC is [examining the practice of creditors utilizing confessions of judgment](#) in small business lending transactions. The Director suggested that, depending on the results of the FTC’s inquiry, the agency might consider [promulgating new regulations or initiating enforcement actions](#). [15 U.S.C. § 57a\(a\)\(1\)\(B\)](#) authorizes the FTC to promulgate “rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce” for the purposes of the Federal Trade Commission Act, while [15 U.S.C. § 57b\(a\)\(1\)](#) empowers the FTC to “commence a civil action against” entities that engage in “unfair or deceptive acts or practices.” The course of action that the FTC ultimately selects could implicate the legal considerations for Congress discussed in the original post below.

Finally, some policymakers have [proposed new laws](#) regulating confessions of judgment at the state level. The [Governor of New York](#), for instance, has advocated (1) codifying the FTC’s Credit Practices Rule described below—which prohibits confessions of judgment in consumer credit transactions—in New York law; (2) prohibiting confessions of judgment in small business loans under \$250,000; and (3) “requiring that any . . . confession of judgment enforced in New York courts have a nexus to business activity in New York.” Such state-level proposals raise various legal questions, including whether prohibiting a state court from honoring an out-of-state confessed judgment in the absence of a nexus to business activity in the enforcing state would comport with the U.S. Constitution’s Full Faith & Credit Clause discussed herein.

The original post from January 3, 2019 is below.

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Contracts sometimes contain provisions—known as “[confession of judgment](#)” or “[cognovit](#)” clauses—pursuant to which one party agrees that if it later breaches the contract, the other party may summarily obtain a legal judgment that it may enforce against the breaching party’s assets. An entity that enters into such a contract thereby [waives](#) significant procedural rights it would otherwise enjoy, such as the right to notice and an opportunity to assert legal defenses against the other party’s claim. Creditors [laud](#) confessions of judgment as an efficient means to collect assets from recalcitrant debtors, as they enable creditors to avoid the “costly and time-consuming” litigation process. Others, however, maintain that confessions of judgment undesirably permit creditors to collect money and assets that they otherwise [could not collect](#) if the debtor retained the ability to assert meritorious legal defenses against the creditors’ claims. As discussed below, these concerns have previously prompted [federal](#) and [state](#) policymakers to restrict the circumstances in which creditors may utilize and enforce confessions of judgment. [Some still contend](#), however, that existing federal laws [do not go far enough](#) to protect debtors from the adverse consequences of confessions of judgment. Thus, several Members of Congress, spurred in part by an [investigative report](#) on confessions of judgment, have recently [introduced legislation](#) to [prevent creditors](#) from utilizing confessions of judgment to collect certain business debts.

This Sidebar discusses the array of legal issues that confessions of judgment implicate. After providing an overview of confessions of judgment, the Sidebar analyzes existing restrictions on the practice under federal and state law. It then describes recent legislative proposals to subject confessions of judgment to heightened federal regulation. The Sidebar concludes by identifying pertinent legal issues for Congress to consider when developing and evaluating such proposals.

Background

Several states, in the interest of facilitating debt collection, authorize creditors to obtain [enforceable judgments](#) against certain types of debtors without engaging in full-fledged litigation. Such [confessions of judgment](#) operate as follows: first, the creditor includes a provision in its contract with the debtor stating that the debtor [consents](#) to have a court enter a monetary judgment in the creditor’s favor in the event of a breach. Such a provision might state, for example: “I hereby acknowledge myself to be justly indebted to, and do hereby [confess judgment](#) in favor of [the creditor] in the sum of [a specified dollar amount].” The debtor then signs the document, thereby [waiving](#) its right to notice of the judgment, as well as its right to assert defenses against the creditor’s claim. If the debtor later breaches the contract, the creditor may then [file the document](#) with the clerk of court to demonstrate that the debtor has agreed in advance to have a judgment entered against it. The court then enters a judgment in the creditor’s favor, which the creditor may then invoke to [collect the debtor’s assets](#) in satisfaction of the debt.

By authorizing creditors to obtain judgments against debtors “[without notice or hearing](#),” confessions of judgment raise potential constitutional concerns. As the U.S. Supreme Court has observed, “notice [of a judicial proceeding] and an opportunity to be heard” are “[fundamental requisites](#) of the constitutional guarantee of procedural due process.” Nevertheless, in 1972, the Supreme Court held in *D.H. Overmyer Co. v. Frick* that confessions of judgment are “not, *per se*, violative of Fourteenth Amendment due process.” According to the Court, because “the due process rights to notice and hearing prior to a civil judgment are subject to waiver,” a debtor who “voluntarily, intelligently, and knowingly” signs a contract with a confession of judgment clause may validly “[waive](#)[] the rights it otherwise possess[e]s to prejudgment notice and hearing.”

Even though there is no *per se* constitutional prohibition against confessions of judgment, however, the *D.H. Overmyer* Court nonetheless [acknowledged](#) the possibility that a confessed judgment may impermissibly deprive a debtor of due process “where the contract [containing the confession of judgment clause] is one of adhesion, where there is great disparity in bargaining power” between the debtor and the creditor, or “where the debtor receives nothing for the cognovit provision.” Lower courts therefore conduct a “[fact-specific inquiry](#)” to evaluate whether a specific confessed judgment violates due process,

examining factors such as the debtor’s sophistication and whether counsel represented the debtor. As a practical matter, however, courts have often rejected debtors’ claims that they did not voluntarily, knowingly, and intelligently consent to a confessed judgment.

Federal Regulation of Confessions of Judgment

In the absence of a categorical constitutional prohibition on confessions of judgment, federal policymakers have opted to regulate confession of judgment clauses in certain respects. In particular, a Federal Trade Commission (FTC) regulation known as the “Credit Practices Rule” declares it a violation of Section 5 of the Federal Trade Commission Act—which empowers the government to police and penalize “unfair or deceptive acts or practices in or affecting commerce”—“for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that . . . [c]onstitutes or contains a cognovit or confession of judgment.” By its plain terms, however, the Credit Practices Rule only applies “in connection with the extension of credit to consumers in or affecting commerce.” The Rule defines “consumer” as “a natural person who seeks or acquires goods, services, or money for personal, family, or household use.” Thus, by its terms, the Rule does not protect corporations, limited liability companies, or other business entities from the adverse consequences of confessions of judgment.

State Regulation of Confessions of Judgment

Because the Credit Practices Rule only applies to consumer lending contracts, the legality of confession of judgment clauses in business contracts depends on state law. Many states have enacted statutes rendering confession of judgment clauses void. A few states even declare it a misdemeanor to induce another person to sign a document containing a confession of judgment provision. Other states, by contrast, authorize their courts to enter confessed judgments so long as the creditor complies with certain substantive and procedural requirements. Under Ohio law, for example, a confession of judgment in a business contract is potentially enforceable if it informs the debtor, “in such type size or distinctive marking that it appears more clearly and conspicuously than anything else on the document,” that:

By signing this paper you give up your right to notice and court trial. If you do not pay on time a court judgment may be taken against you without your prior knowledge and the powers of a court can be used to collect from you regardless of any claims you may have against the creditor.

States that authorize confessed judgments generally grant debtors a window of time during which they may ask the court to vacate the judgment. A debtor’s challenge to a confessed judgment will generally fail, however, if the debtor does not promptly seek relief from the court that originally entered the judgment.

Critically, however, states cannot necessarily shield their residents from confessed judgments entered in other states. Because the Full Faith and Credit Clause of the U.S. Constitution requires states to honor judgments that are validly entered by a court of competent jurisdiction in another state, a confessed judgment issued by a court of a state that authorizes confessed judgments may be enforceable against a debtor that resides in a different state that restricts or prohibits confessions of judgment. Thus, to illustrate, the Supreme Court of Florida has ruled that Florida courts must honor confessed judgments validly issued by courts in other states, even though Florida law prohibits Florida courts from entering confessed judgments themselves.

Legal Considerations for Congress

Members of recent Congresses have introduced a variety of bills to regulate confessions of judgment in several different respects. For example, the Small Business Fair Lending Act from the 115th Congress (S. 3717/H.R. 7354) would have amended the Truth in Lending Act to prohibit any creditor from “directly or indirectly tak[ing] or receiv[ing] from a borrower an obligation that constitutes or contains a cognovit or

confession of judgment” “[i]n connection with the extension of credit in or affecting commerce.” That bill would have therefore **codified** the Credit Practices Rule’s prohibitions on confessions of judgment in the consumer lending context while **expanding** the Rule’s protections to business contracts.

There are several legal issues for Congress to consider if it chooses to impose greater regulations on confessions of judgment. The first question is how broadly the legislation will sweep: Congress could restrict or prohibit confession of judgment clauses in a wide swath of contracts, or it could instead enact legislation that applies only to a limited subset of contracts, creditors, or debtors. For instance, whereas several **legislative proposals** introduced in **past Congresses** would have only restricted the use of confession of judgment clauses in **specific types of contracts** (such as **franchise agreements**), bills like the Small Business Fair Lending Act would have applied **more broadly** to prohibit confession of judgment clauses in any contract “in connection with the extension of credit in or affecting commerce.” Significantly, drafting the legislation more broadly could potentially result in federal law preempting a wider array of state statutes that currently authorize confessions of judgment in certain contexts.

Another issue is whether the legislation would apply retroactively to render confession of judgment clauses in existing contracts unenforceable. The **Supreme Court**, opining that “elementary considerations of fairness dictate that . . . settled expectations should not be lightly disrupted,” has generally **declined** to afford statutes retroactive effect “absent a clear indication from Congress that it intended such a result.” In the present context, invalidating confession of judgment clauses in existing contracts could potentially disrupt the settled expectations of creditors, who could lose a valuable contractual right. Perhaps for that reason, the **Credit Practices Rule** only purports to constrain creditors from including confession of judgment clauses in new contracts formed after the Rule’s effective date—the FTC has taken the position that contracts signed *before* the Rule’s effective date remain “**enforceable** and not in violation of the Rule” even if they contain confession of judgment provisions.

In addition to the aforementioned issues, regulating confessions of judgment at the federal level raises other legal questions, including:

- Whether the **responsibility for enforcing** the new law will be entrusted to a **federal agency**, individual debtors, or both;
- Whether creditors who enter into contracts containing unlawful confession of judgment provisions will be subject to penalties—and, if so, what those penalties will be and to whom they will be paid;
- Whether (and to what extent) the existence of a confession of judgment clause in a contract will render that contract partially or entirely unenforceable; and
- Whether (and under what circumstances) debtors will be allowed to collaterally attack the validity of confessed judgments entered by state courts in a subsequent judicial proceeding in the same court or a different court.

If the 116th Congress chooses to continue the 115th Congress’s work on regulating confessions of judgment, it may need to consider these varied legal issues implicated by confession of judgment clauses.

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