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Despite Challenges, Cognovits Continue to Drive Ohio's Favorable Banking Climate

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Lenders in Ohio frequently incorporate cognovits, or confession of judgment provisions, into promissory notes, guaranties and other loan instruments. These provisions offer lenders an efficient, expedited and cost-effective process to commence collection efforts against borrowers in the event of a default on a commercial loan. While their validity is deeply rooted in both statutory and case law in Ohio and elsewhere (and has been for decades), critics occasionally denounce cognovits as unfair and violative of due process, and efforts have been made to modify, eliminate or even criminalize the use of cognovits. From a policy perspective, while the benefits of cognovits to lenders are readily apparent, borrowers and third-party stakeholders realize certain benefits as well. While the cognovit process does present some inherent challenges, it remains a critical driver of both an accessible banking industry and a robust Ohio economy.

Cognovit Procedure Under Ohio Law

A cognovit is a written admission executed by a borrower that acknowledges the liability of the borrower and authorizes the entry of judgment against the borrower (without notice or the opportunity to be heard) in the event of default. **Importantly, Ohio only permits cognovits in connection with commercial loans**, rather than consumer loans (i.e., a debt incurred primarily for a personal, family, educational or household purpose). In order for a cognovit to be enforceable in Ohio, a lender must ensure that the debt instrument complies with the statutory requirements of O.R.C. § 2323.13.

Under O.R.C. § 2323.13, the debt instrument must prominently state, "in such type size or distinctive marking that it appears more clearly and conspicuously than anything else on the document," the following cautionary language:

“Warning – 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 whether for returned goods, faulty goods, failure on his part to comply with the agreement, or any other cause.”¹

In addition, immediately preceding or following the warning, a borrower must execute a “warrant of attorney,” authorizing an attorney appointed by the lender to confess judgment on the borrower’s behalf in the event of default.

After the parties have executed the debt instrument, the lender then holds the debt instrument until the borrower repays or defaults. In the event of default, the lender, by relying on the cognovit provisions in the debt instrument, can initiate an expedited procedure to obtain judgment. Assuming jurisdiction is established, if the debt instrument is properly executed in accordance with O.R.C. § 2323.13, the court will enter a cognovit judgment, permitting the lender to seek all available legal remedies against the defendant-debtor, without the burden of a full trial.

Benefits for Lenders, Borrowers and Third-Party Stakeholders

For lenders, the primary benefits of cognovits are speed and risk mitigation. Cognovits provide lenders with immediate access to both the courts and the debtor’s assets in the event of default. Lenders can quickly commence collection efforts, avoiding timing delays and court congestion. Delays and court congestion can and often do adversely impact the ability of a lender to maximize collection on the underlying debt. The cognovit process reduces collection time, costs and, importantly, the likelihood that critical borrower assets will dissipate before recovery can occur. This expedited process results in increased loan collection rates and important payment leverage for lenders. Broadly, cognovits help mitigate the risks and decrease the transaction costs associated with commercial lending.

As a result, borrowers and communities receive enhanced access to credit. Without realizing the benefits of cognovits, lenders would be forced to significantly tighten their lending standards. Across the industry, lenders would issue fewer, less-sizeable loans and raise interest rates to reflect the increased risks and higher collection costs. Riskier borrowers may not qualify for a loan at all without the lender’s cognovit safety net. For those borrowers who do qualify, lenders may require additional guarantees or forms of security. The increased risk to lenders directly correlates with increased costs for borrowers. As a result, with the ability to use cognovit provisions, lenders in Ohio can offer borrowers more favorable terms than are available in other jurisdictions that do not have cognovit opportunities. As such, the use of cognovit provisions makes the banking industry much more accessible to commercial borrowers and communities, allowing for important growth opportunities and enhanced employment opportunities in construction, manufacturing, and a variety of other industries.

Various third-party stakeholders also realize the benefits of cognovits. Cognovits provide additional collection comfort for bank regulators, accountants and auditors in assessing loan quality. As previously noted, the cognovit process aids debt collection efforts on commercial loans. Elimination of cognovits would both increase the risk profile of commercial loans and impede important collection efforts, resulting in asset dissipation and decreased collection rates. Ultimately, an elimination of cognovits would affect lenders’ bottom lines and fail to maximize shareholder value. Additionally, since commercial loans are comprised of depositor money, deposits are safer when lenders’ collection rates increase. Thus, cognovits

protect bank assets for the benefit of both shareholders and depositors, as well as borrowers and the communities in which they operate.

Challenges for Borrowers

While the benefits of cognovits are evident, they do present certain challenges for commercial borrowers. For example, a borrower will incur costs making sure it remains in compliance with the terms of a debt instrument. During the term of a loan, borrowers must monitor the projects funded by the loan on an ongoing basis to make certain that they remain in compliance with the underlying loan terms. Even non-monetary defaults can trigger serious consequences, and often arise as a result of a borrower oversight, or even a mistake. Additionally, borrowers must keep an ongoing line of communication open with their lender.

Conclusions

Overall, while cognovits assist lenders in the critical collection process, multiple constituencies also reap their benefits. These benefits include both borrowers and communities being impacted by economic expansion—expansion made available by increased access to credit. Expanded credit accessibility is due in significant part to lender reliance on the protections afforded by cognovit provisions contained in commercial loan agreements. Thus, Ohio's longstanding cognovit laws continue to facilitate, rather than hinder, funding for qualifying projects, fostering economic development and job growth in Ohio communities. As a result, cognovits are, and remain, a critical contributor to credit access in Ohio's banking climate.

¹ O.R.C. § 2323.13(D).