

Written testimony of

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Committee on Small Business
“Crushed by Confessions of Judgement: The Small Business Story”

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Witness Background Statement

Anne Fleming is a Professor of Law at Georgetown University Law Center, where she teaches courses on contracts, bankruptcy, secured transactions, and consumer finance. Professor Fleming's research examines the relationship between law and business over time, with a focus on the financial services industry and its regulation.

She is the author of *City of Debtors: A Century of Fringe Finance* (Harvard Univ. Press, 2018), which explores the growth and regulation of small-dollar lending institutions in the United States over the twentieth century. In 2019, *City of Debtors* won the Ralph Gomory book prize from the Business History Conference and the best book award from the American College of Consumer Financial Services Lawyers.

Professor Fleming's other scholarship has examined the history of "truth-in-lending" laws, the intersection of legal history and economic history, and the role of the doctrine of unconscionability in protecting poor consumers. The American Society for Legal History has recognized her work with the Kathryn T. Preyer Scholars Award and a William Nelson Cromwell Foundation Fellowship. She has also received the K. Austin Kerr prize and the Herman E. Krooss dissertation prize from the Business History Conference.

Prior to entering academia, Professor Fleming practiced law as a staff attorney for South Brooklyn Legal Services, representing low-income homeowners facing foreclosure. She also served as a law clerk to the Honorable Marjorie O. Rendell of the U.S. Court of Appeals for the Third Circuit and the Honorable Miriam Goldman Cedarbaum of the U.S. District Court for the Southern District of New York.

Professor Fleming received her J.D., *magna cum laude*, from Harvard Law School. She also holds a Ph.D. in History from the University of Pennsylvania and a B.A. from Yale University. Prior to joining the Georgetown faculty, she taught at Harvard Law School as a Climenko Fellow and Lecturer on Law.

Professor Fleming has not received any federal grants or any compensation in connection with her testimony, and she is not testifying on behalf of any organization. The views expressed in her testimony are solely her own.

Chairwoman Velázquez, Ranking Member Chabot, and Members of the Committee:

Thank you for holding a hearing on the impact of confessions of judgment on small businesses, and for inviting me to submit written testimony.

A confession of judgment is an incredibly powerful debt collection tool. The debtor signs away the right to oppose the creditor's claim for damages and to assert otherwise-valid defenses in court. With the aid of a confession, the creditor can then obtain a money judgment quickly and at low cost after declaring a default, before proceeding to seize the debtor's property. It is no wonder that some creditors have required small businesses to execute a confession of judgment as a condition of receiving a loan.

More than thirty years ago, the Federal Trade Commission (FTC) found creditors' use of confessions of judgment in consumer lending to be an unfair practice. Accordingly, since 1985, the FTC has banned the use of confessions in connection with consumer loans under its Credit Practices Rule.¹

Furthermore, even before the FTC rulemaking, a number of states banned the use of confessions for all or some subset of consumer loans, based on similar concerns. New York, for example, banned the use of confessions in connection with small-sum loans in the 1930s and for all retail installment sales contracts in the 1950s.² But the "Full Faith and Credit" Clause of the U.S. Constitution requires states such as New York to enforce judgments validly obtained in other states, including judgments obtained by confession.³ Thus, New York and other states could only go so far to protect their residents from confessions of judgment. Federal action was necessary.

Constitutional constraints have likewise hampered state-level efforts to regulate the use of confessions in commercial transactions.⁴ Although some states have banned the use of confessions entirely, these bans are ineffective because lenders can still enforce judgments by confession obtained in states that allow them. Accordingly, in the absence of action by all fifty states, no state can fully protect its small business owners from confessions of judgment.

In the 1980s, the FTC decided to ban confessions for consumer loans based on several findings. First, it found that consumers suffered "substantial economic or monetary injury" from creditors' use of confessions.⁵ It also found that consumers could not reasonably avoid confessions or the "harsh consequences" that flowed from their use. The FTC then acknowledged that banning confessions could increase creditor costs, which could then be passed on to borrowers in the

¹ FTC Credit Practices Rule, 49 Fed. Reg. 7740 (1984).

² ANNE FLEMING, CITY OF DEBTORS: A CENTURY OF FRINGE FINANCE 79, 168 (2018).

³ Article IV of the U.S. Constitution states that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

⁴ For example, see *C.F. Trust v. Peterson*, 6 Mass. L. Rep. 505 (1997) (finding that the constitutional "principles of full faith and credit mandate" state enforcement of a confessed judgment if valid where rendered, even if confessions are "repugnant" to the state's "own statutes").

⁵ FTC Credit Practices Rule, 49 Fed. Reg. at 7740.

form of higher interest rates, reduced credit availability, or other restrictions on loan terms. But, after weighing the costs and benefits, the FTC ultimately concluded that the overall costs to consumers were greater than the benefits derived from confessions. Based on these findings, the FTC banned the use of confessions in consumer lending.

Federal law now draws a bright line between loans to consumers and to businesses when regulating confessions of judgment. It affords significant protection to consumers and almost none to businesses. Yet, the concerns that motivated the FTC ban on confessions for consumers also arise when the borrowers are owners of small businesses – like the neighborhood pizzeria, bodega, auto repair shop, or florist. Small business borrowers also suffer substantial injuries from confessions, which they cannot reasonably avoid.

Substantial harm to small business borrowers

Like consumers, small businesses and their employees may also suffer substantial economic injury from creditors' use of confessions of judgment. The business can lose access to the funds in its bank account without advance warning, after its creditor obtains a judgment and issues notice to the debtor's bank. If the business is locked out of its bank accounts, it then cannot meet payroll for its workers, who have their own bills to cover. True, the bank account belongs to the business. But the seizure directly impacts small business employees and their households.

Furthermore, individual small business owners also stand to lose their *personal* property without warning as a result of signing a confession for a business loan. A 2017 Federal Reserve survey of small business employers found that the majority (55%) personally guaranteed their business loans and a third (33%) pledged their personal assets as collateral.⁶ If small business owners sign a personal guarantee of the business loan and a confession of judgment, the lender can then seize the individual owners' personal bank accounts and other property, along with the business's assets, upon declaring a default. The harm caused by such a deprivation of household property is no less significant merely because the loan proceeds were used to fund a small business venture rather than to buy household goods or services.

The FTC banned confessions for consumer loans based in part on evidence of the harms inflicted on consumers by sudden deprivations of their household property.⁷ These same harms arise out of the use of confessions in the small business context.

Difficulty of avoiding harm for small business debtors

⁶ FEDERAL RESERVE, SMALL BUSINESS CREDIT SURVEY: REPORT ON EMPLOYER FIRMS 5 (2017), *available at* <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-employer-firms-report.pdf>. Non-employer small businesses likewise reported frequent use of personal guarantees (39%) and pledging of personal assets (26%) to secure their business debts. FEDERAL RESERVE, SMALL BUSINESS CREDIT SURVEY: REPORT ON NONEMPLOYER FIRMS 8 (2018), *available at*

<https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-nonemployer-firms-report.pdf>.

⁷ FTC Credit Practices Rule, 49 Fed. Reg. at 7749.

Nor are most small business owners better equipped than most consumers to protect themselves from these sudden deprivations of property. Many small business owners are no more legally sophisticated than the average consumer and no more likely to have an attorney review a loan contract before signing it. In terms of legal sophistication, many small business owners are more akin to consumers than to big businesses.

When the FTC studied confessions of judgment for consumer loans, it found that many consumers did not understand that they were signing a confession or that a confession constituted a waiver of their right to contest the creditor's claim in court.⁸ Because consumers possessed a limited understanding of confessions of judgment, they also did not negotiate over the terms or shop around for loans without confessions.

Evidence suggests that small business owners suffer from similar deficits of understanding. For example, Doug and Janelle Duncan, the owners of a Florida real estate agency, both signed confessions as a condition of receiving a merchant cash advance – without consulting an attorney.⁹ As reported by *Bloomberg News*, the borrowers paid a steep price: the loss of their business and their retirement savings. Most states do not require a borrower to receive legal advice from an attorney before entering into an enforceable confession of judgment.¹⁰ In nearly all states that allow confessions, small business owners can sign away their right to contest a creditor's collection suit without fully understanding the risk assumed.

To be sure, some small business owners do have legal training or some greater degree of legal sophistication, just as some consumers do. Legal sophistication exists along a spectrum. But a borrower's reason for taking out a loan – whether to fund small business operations or to pay for household goods and services – does not determine where he or she falls along this spectrum. Over the course of their lives, small business owners will likely incur both business and consumer debts and will grant creditors the right to pursue their personal property in satisfaction of both types of debt. These individuals acquire no greater legal sophistication when they are borrowing as small business owners, rather than as individual consumers.

Yet, federal law makes a strong distinction between these two contexts. It offers no protection from confessions of judgment to an individual who borrows to fund a business. But it offers complete protection to the same individual when he or she borrows to fund consumption.

Minimal impact on access to and cost of small business credit

The strongest argument in favor of allowing confessions of judgment is that they lower lenders' costs to collect defaulted loans, and thereby lower the cost of credit and improve access to capital for small businesses. If confessions are banned, creditors might start charging small business

⁸ FTC Credit Practices Rule, 49 Fed. Reg. at 7749, 7753.

⁹ Zachary Mider and Zeke Faux, *'I Hereby Confess Judgment'*, BLOOMBERG NEWS, Nov. 20, 2018.

¹⁰ California has this requirement. Cal. Code Civ. Proc. 1132.

borrowers higher interest rates or refuse to lend to some entirely, in order to compensate for their higher collection costs.

But this risk is mitigated by the availability of other security devices. If Congress were to ban the use of confessions for small business loans, lenders would still be able to require borrowers to grant a security interest in their assets, including accounts receivable and deposit accounts. And lenders would also still be able to go to court to get a money judgment against debtors who default. And lenders could still require debtors to agree to pay the creditor's court costs and attorneys' fees incurred in any collection actions. A ban on confessions of judgment would deprive small business lenders of one remedial tool, but would not empty their whole arsenal.

Consumer lenders and borrowers have managed to get along without confessions of judgment for more than thirty years. Small business lenders and borrowers could do the same.

Conclusion

Large businesses and consumers rest on opposite ends of a spectrum, in terms of their legal sophistication and the nature of the harms they suffer when deprived of access to their property without warning. Small businesses fall somewhere between these two poles. But many small business owners are more akin to consumers than large enterprises – both in their legal sophistication and their vulnerability to loss.

Yet, federal law governing confessions of judgment currently lumps together all business debtors, despite the wide variety of enterprises that fall within the business category and their differences from one another.

Applying the “business” label to a loan does not make the individual borrower any more sophisticated or a sudden loss of property any less painful. As recent investigations have shown, plumbers, cab drivers, and other small business owners are just as vulnerable as consumers to losing everything that they have worked to achieve.¹¹ These losses will continue to pile up in the absence of legal constraints on the use of confessions in small business lending.

Banning confessions of judgment for small business loans would bring the law into closer conformity with the messy reality of debtor-creditor relationships – a reality that is not well captured by a bright-line distinction between consumer debtors and business debtors. And it would ensure that similar groups of borrowers – consumers and small business owners – receive similar legal protections against similar harms.

¹¹ Zachary Mider and Zeke Faux, *I Hereby Confess Judgment*, BLOOMBERG NEWS, Nov. 20, 2018; Brian M. Rosenthal, *They Were Conned’: How Reckless Loans Devastated a Generation of Taxi Drivers*, NEW YORK TIMES, May 19, 2019.