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Consumer Protection -- Disclosure of Cognovit Provisions as Security Interests Under the Truth in Lending Act

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upon the discretion of an executive official. In view of this danger the recent denial of certiorari by the Supreme Court[63] is disappointing. Hopefully, the determining factor in the denial was that no attempt to restrain publication of specific material has yet been made.[64] If so, the Court, upon actual submission of material and denial of authorization to publish, could still determine that judicial review of the classification system is necessary for the protection of our cherished freedoms of speech and press.

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Consumer Protection—Disclosure of Cognovit Provisions as Security Interests Under the Truth in Lending Act

The Truth in Lending Act,[1] which became effective on July 1, 1969, provides: "[I]t is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."[2] Pursuant to authority granted by the Act,[3] the Board of Governors of the Federal Reserve System has published Federal Reserve Board Regulation Z[4] to implement the purposes of the Act. Prior to the passage of the Truth in Lending Act, it was impossible for most consumers to purchase credit in any rational or intelligent manner.[5] The problem was not simply an inability to understand complex finance charges, for consumers were (and still are) often intimidated by the legalistic language that is so lavishly employed in both the large and fine print of loan instruments.

Creditors often retain security interests[6] within the body of loan

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[63]93 S. Ct. 553 (1972).

[64]McCormick, *Marchetti v. United States*, N.Y. Times, Dec. 30, 1972, at 21, cols. 5-6 (city ed.).

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[1]15 U.S.C. §§ 1601-65 (1970).

[2]*Id.* § 1601.

[3]*Id.*

[4]12 C.F.R. Part 226 (1972).

[5]B. CLARK & J. FONESCA, HANDLING CONSUMER CREDIT CASES 137 (1972) [hereinafter cited as CLARK & FONESCA].

[6] "Security interest" and "security" mean any interest in property which secures payment or performance of an obligation. The terms include, but are not limited to, security interests under the Uniform Commercial Code, real property mortgages,

instruments. This may be unknown to the debtor, or if known, the legal effect is generally not fully understood.[7] For this reason, the Truth in Lending Act requires that creditors disclose security interests that arise from consumer credit sales that are not connected with an open-end credit plan.[8] In a recent case, *Douglas v. Beneficial Finance Co.*,[9] the United States Court of Appeals for the Ninth Circuit has reached an unsatisfying result by reversing the district court and holding that a confession of judgment or cognovit clause[10] need not be disclosed as a security interest by creditors in Alaska. The court arrived at this result in a manner that seems overly technical and against the spirit and purpose of the Truth in Lending Act.[11]

Sandra Douglas had instituted a class action against Beneficial Finance Company by charging that Beneficial had violated the Act by failing to make disclosure of confession of judgment clauses contained in promissory notes taken as evidence of debts owed by members of the class to Beneficial.[12] The cognovit clause employed by Beneficial provided that the debtor consented to the jurisdiction of any state and that Beneficial could have judgment by confession without notice. The clause also provided that the debtor waived all rights of exemption and that no lien would be created on any real property used as a principal residence during the term of the note.[13]

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deeds of trust, and other consensual or confessed liens whether or not recorded, mechnic's, materialmen's, artisan's, and other similar liens, vendor's liens in both real and personal property, the interest of a seller in a contract for the sale of real property, any lien on property arising by operation of law, and any interest in a lease when used to secure payment or performance of an obligation.

12 C.F.R. § 226.2(z) (1972).

[7]CLARK & FONESCA 110.

[8]15 U.S.C. § 1638(a)(10)(1970). Under an open-end credit plan (such as a credit card or revolving charge account), the Act requires disclosure of "[t]he conditions under which the creditor may retain or acquire any security interest in any property to secure the payment of any credit extended under the plan . . . ." *Id.* § 1637(a)(7).

[9]469 F.2d 453 (9th Cir. 1972).

[10]A confession of judgment or cognovit clause, sometimes referred to as a warrant of attorney, generally takes the form of a consent given by the debtor to the jurisdiction of any forum along with authorization for the creditor's attorney to appear and confess judgment against him. Both notice and opportunity to defend are waived.

[11]*See* text accompanying note 2 *supra.*

[12]469 F.2d at 454. The district court held that Beneficial did not have standing to challenge the constitutionality of the cognovit clause. Douglas v. Beneficial Finance Co., 334 F. Supp. 1166, 1176 (D. Alas. 1971).

[13]The clause in question reads as follows in all of the notes:

Undersigned jointly and severally authorize and empower any attorney of law of any court of record of the State of Alaska or elsewhere in the United States to appear

The Act requires that creditors disclose "[a] description of any security interest held or to be retained or acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates."[14] Any debtor to whom a creditor fails to make the required disclosures may bring an action against the creditor for damages.[15] In such an action the debtor may recover twice the amount of finance charges with the limitation that the total amount of recovery may not be less than one hundred dollars nor greater than one thousand dollars.[16] In addition, if the action is successful the debtor may recover the costs of the action along with reasonable attorney's fees.[17] The debtor has the right to rescind any transaction in which the creditor acquires a security interest in any real property if the property is or is expected to be used as the principal residence of the debtor.[18] This right to rescind may be exercised only until midnight of the third business day after the transaction is consummated[19] if the creditor discloses to the debtor his rights under section 1635. The debtor has an indefinite right to rescind, however, if the creditor fails to make the required notice and disclosure.[20] Douglas sought damages for herself and the members of their class and sought the right to rescind for those members of the class who owned real property used or expected to be used as a principle residence.[21]

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for undersigned, or any one of undersigned, on an action on this note in any court of the United States, State of Alaska or elsewhere in the United States at any time after default in the payment of the amount of any installment of principal and interest thereon, and confess judgment against any one or all of the undersigned for the amount due with interest and charges permitted by said Section 06.20.260, of the Alaska Statutes, all without any benefit of valuation and appraisal laws. All parties hereto severally waive demand and presentment for payment, notice of nonpayment, notice of protest and protest of this note and agree that their liability hereunder shall not be affected by any extension of the time of payment of all or any part of the amount owing hereon at any time or times, and further waive all rights of exemption under the laws of this State. It is understood and agreed that this clause shall not operate to create a lien on any real property owned and occupied by the undersigned as a principle residence at any time during the term of this note.

334 F. Supp. at 1170.

[14]15 U.S.C. § 1638(a)(10) (1970).

[15]15 U.S.C. § 1640(a) (1970).

[16]15 U.S.C. § 1640(a)(1) (1970).

[17]15 U.S.C. § 1640(a)(2) (1970).

[18]15 U.S.C. § 1635(a) (1970).

[19]*Id.*

[20]Letter from Griffith L. Garwood, December 30, 1969, in 4 CCH Consumer Credit Guide ¶ 30,245 at 66,112 (1972).

[21]334 F. Supp. at 1178.

Security interests are defined in Federal Reserve Board Regulation Z to include "other consensual or confessed liens whether or not recorded."[22] Critical to the decisions of both the district court and the court of appeals is the Board's Interpretation of the definition of "security interest:"

> (b) In some of the States, confession of judgment clauses or cognovit provisions are lawful and make it possible for the holder of an obligation containing such clause or provision to record a lien on property of the obligor simply by recordation entry of judgment; the obligor is afforded no opportunity to enter a defense against such action prior to entry of the judgment.
> (c) Since confession of judgment clauses and cognovit provisions in such States have the effect of depriving the obligor of the right to be notified of a pending action and to enter a defense in a judicial proceeding *before* judgment may be entered or recorded against him, such clauses and provisions in those states are security interests . . . .[23]

The district court held that the confession of judgment clause used by Beneficial in its notes[24] was a security interest requiring disclosure under section 1639(a)(8) of the Act.[25]

Alaska has a statute which purports to make confessions of judgment lawful even without notice.[26] However, the district court's interpretation of the requirements of rule 57(c) of the Alaska Rules of Civil Procedure[27] would preclude entry of judgment without notice because rule 93 provides for the superiority of the rules when there is a conflict with any other statutory provision concerning procedure.[28] Consequently, the district court predicated its damage award for failure to disclose a security interest on the impact of a confession of judgment clause:

> It is frequently stated that a forum court in a conflict of law situation

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[22] *See* note 6 *supra.*

[23] Federal Reserve Board Regulation Z Interpretation, 12 C.F.R. § 226.202(b)-(c) (emphasis added).

[24] *See* note 13 *supra.*

[25] 334 F. Supp. at 1170.

[26] ALASKA STAT. § 09.30.050 (1962).

[27] The confession shall be made, assented to and acknowledged and judgment given in the same manner as a confession in an action pending, but in addition, the confession shall be verified by the oath of the person making it, and shall authorize a judgment to be given for a particular sum.
Alaska R. Civ. P. 57(c)(2).

[28] 334 F. Supp. at 1171.

> will apply its . . . own procedural law. [Citing Lillegraven v. Tengs, 375 P.2d 139 (Alaska 1962).] If, as defendant contends and Rule 57 implies, the entry of judgment pursuant to a confession is a procedural matter, then the forum state need not apply Alaska Rule 57. If, on the other hand, confession of judgment is a matter of substantive law, then Rule 93 would be inapplicable and A.S. 09.30.050 would permit entry of judgment without notice, not only in Alaska, but in any state looking to Alaska law. In either case the confession of judgment clause runs afoul of the Truth in Lending Act.[29]

The Court of Appeals reversed. The notes were executed in and subject to the laws of Alaska. The appellate court relied on the absence of any evidence that would indicate that Beneficial had ever secured judgments in other states as hypothesized by the lower court.[30] Then the court proceeded:

> In such circumstances, we hold that the district court's decision disregards the Board's interpretation of its regulation, which states that confession of judgment clauses are security interests "in those States" in which judgment may be entered without notice and hearing. The district court's view would make this limitation meaningless.[31]

Confessions of judgment are not held in high regard by many commentators.[32] The courts have also given the practice rather close scrutiny in recent cases.[33] However, the practice was able to survive a constitutional attack under the due process clause in two recent United States Supreme Court decisions, *D.H. Overmeyer Co. v. Frick Co.*[34] and *Swarb v. Lennox*,[35] that held that confessions of judgment were not illegal *per se*.[36] Nevertheless, the correctness of the decision in *Douglas* must depend upon the Truth in Lending Act and the prescriptions of

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[29]*Id.* at 1173.

[30]469 F.2d at 456.

[31]*Id.*

[32]"There is a nearly unanimous feeling of distaste toward the cognovit note . . . ." CLARK & FONSECA 111. *But see* Note, *Consumer Protection—Truth in Lending and the Cognovit Judgment*, 1970 WIS. L. REV. 216 (1970) in which the procedure is defended as it is applied in Wisconsin on the grounds of economy and efficiency.

[33]*E.g.*, Osmond v. Spence, 327 F. Supp. 1349 (D. Del. 1971); Atlas Credit Corp. v. Ezrine, 25 N.Y.2d 219, 250 N.E.2d 474, 303 N.Y.S.2d 382 (1969).

[34]405 U.S. 174 (1972).

[35]405 U.S. 191 (1972).

[36]For a discussion of *Overmyer* and *Swarb*, *see* Note, *Constitutional Law—Cognovit Notes: Pretrial Waiver of Constitutional Rights in Civil Cases*, 51 N.C.L. REV. 554 (1973).

the Board of Governors of the Federal Reserve System rather than upon the esteem in which the device of confession of judgment is held.

In fact, the Court of Appeals reversed the district court's interpretation of the pertinent statutory and regulatory material only so far as the meaning to be afforded the Board's Interpretation of section 226.2(z) of Regulation Z.[37]

It is true that the Board interprets confession of judgment clauses to be security interests only *"in those States"* in which a judgment can be awarded without notice and a hearing.[38] However, it is also true that the Board said, "In some of the States, confession of judgment clauses or cognovit provisions are lawful and *make it possible* . . . to record a lien on property . . . simply by recordation entry of judgment . . . ."[39] While the choice of law rules in this area are confused and diverse,[40] it seems clear that many states would probably apply the Alaska law in passing upon the validity of cognovit notes *executed* in Alaska.[41] Furthermore, Alaska courts would probably give full faith and credit to judgments taken on such notes in other states.[42] However, in *Atlas Credit Corp. v. Ezrine*,[43] the New York Court of Appeals held that judgments obtained in Pennsylvania under a cognovit note were not entitled to full faith and credit as they were not true judgments and that judgments obtained under cognovit notes violate due process of law. Since Alaska has a specific statutory provision providing for cognovit notes, its courts might be less likely to follow the lead of New York.[44] Therefore, it would seem that the district court's "hypothetical" is realistic and that Alaska law may "make it possible"[45] to acquire a judgment by confession.

The Board's interpretation must share the blame for the Court of Appeals decision. The interpretation is ambiguous and clearly admits of the meaning applied to it by the appellate court. However, the over-

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[37]*See* text accompanying note 23 *supra*.

[38]12 C.F.R. § 226.202(c) (1972) (emphasis added).

[39]12 C.F.R. § 226.202(b) (1972) (emphasis added).

[40]*See generally* Hopson, *Cognovit Judgments: An Ignored Problem of Due Process and Full Faith and Credit*, 29 U. CHI. L. REV. 111 (1961); Wurfel, *Choice of Law Rules in North Carolina*, 48 N.C.L. REV. 243 (1970).

[41]*See* 47 AM. JUR. 2d *Judgments* § 1120, at 166-68 (1969); Schuchman, *Confession of Judgment as a Conflict of Laws Problem*, 36 NOTRE DAME LAWYER 461, 464-65 (1961).

[42]*See* Annot., 39 A.L.R.2d 1232 (1955).

[43]25 N.Y.2d 219, 250 N.E.2d 474, 303 N.Y.S.2d 382 (1969).

[44]334 F. Supp. at 1171.

[45]12 C.F.R. § 226.202(b) (1972).

riding purpose of the Act is to require disclosure; it is concerned with state law only to the extent of ensuring that consumers have the necessary information so that they may make a more rational use of credit. The Truth in Lending Act seeks to protect the consumer-debtor,[46] and the effect upon him is the same no matter what legal process is employed in securing the judgment against him. Consequently, the detrimental effects of a confession of judgment clause dictate that it be included within the interpretation of security interest unless it is clearly excluded by the Federal Reserve Board regulations or interpretations. Therefore the district court's decision would seem to be more closely aligned with the purpose and spirit of the Truth in Lending Act.

Since the court of appeals decided that the cognovit provisions contained in Beneficial's notes were not security interests requiring disclosure under the Turth in Lending Act, the issue of rescission was not reached. The district court did reach the issue and found that the right to rescind existed.[47]

The Truth in Lending Act makes the following provision concerning rescission:

> Except as otherwise provided in this section, in the case of any consumer credit transaction in which a security interest is retained or acquired in any real property which is used or is expected to be used as the residence of the person to whom credit is extended, the obligor shall have the right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of the disclosures required under this section . . . .[48]

The pertinent language of Regulation Z provides for recission where "a security interest is or *will be* retained or acquired"[49] in the debtor's residential real property. The Board's Interpretation of section 226.2 says that cognovit clauses are security interests "even if the judgment cannot be entered until after a default by the obligor."[50] However, when a cognovit clause expressly states that all liens upon residential real property are excluded from its operation, then the right to rescind does not apply.[51]

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[46]*See* text accompanying note 2 *supra.*

[47]334 F. Supp. at 1178.

[48]15 U.S.C. § 1635(a) (1970).

[49]12 C.F.R. § 226.9(a) (1972) (emphasis added).

[50]12 C.F.R. § 226.202(c) (1972).

[51]*Id.* § 226.202(d).

Beneficial's note contained this sentence: "It is understood and agreed that this clause shall not operate to create a lien on any real property owned and occupied by the undersigned as a principle residence at any time *during the term of this note.*"[52]

The district court held that the unlimited right to rescind applied since the note would expire upon default by the debtor and entry of judgment and Beneficial would not be precluded by the terms of the note from recording a lien upon the debtor's home after judgment because the debtor waived all exemption rights.

There is no reason to believe that the language in Beneficial's notes concerning real property was included for any reason other than to comply with the Board's Interpretation that precludes rescission if the cognovit clause expressly excludes liens upon real property.[53] Beneficial has given with one hand while taking away with the other. The district court decided correctly in holding that this is not enough.

Overmeyer and *Swarb* have left the constitutional status of the cognovit note uncertain. A clear holding of unconstitutionality would have completely eliminated the problem. Some states do not allow the use of cognovit notes,[54] some allow it with procedural restrictions (*e.g.*, Alaska),[55] and some allow the use of cognovit notes at least to some extent without notice and hearing.[56] If a note containing a cognovit provision is executed in a state which prohibits the use of cognovit provisions and judgment is sought there, then no problem arises. Again, there is no problem when a note is executed in a state where the procedural laws require that notice and a hearing be given to the debtor—there would be no security interest under the Truth and Lending Act and the consumer is protected by notice and hearing. If a cognovit note is executed in a state permitting the use of cognovit provisions and judgment is sought there, then clearly disclosure must be made under the Act.[57] The difficulty arises when a note is executed in a state

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[52]*See* note 13 *supra* (emphasis added).

[53]12 C.F.R. § 226.202(d) (1972).

[54]Note, *Due Process—Confession of Judgment Procedures Are Not Unconstitutional Per Se*, 25 VAND. L. REV. 613, 613 n.3 (1972); Note, *Constitutional Law—Confession of Judgments—Pennsylvania Entry of Judgment by Confession Procedure Based Upon Waiver of Notice Without Adequate Understanding by the Debtors Held Violative of the Due Process Clause of the Fourteenth Amendment*, 16 VILL. L. REV. 571, 573 n.9 (1971).

[55]*See* note 54 *supra.*

[56]*Id.*

[57]12 C.F.R. § 226.2(z) (1972).

where the use of cognovit provisions is limited in some way and judgment is later sought in another state with unrestricted cognovit provisions. The state in which the judgment is sought could grant the judgment without notice and hearing either through the application of its own nonrestrictive laws or through application of its own procedural rules in conjunction with the substantive law regarding the use of cognovit provisions of the state of execution.

The district court's solution to this problem was to require disclosure in any case where it is *possible* for a creditor to obtain a judgment against the debtor through the use of a cognovit clause without notice and hearing. The court of appeals, by dwelling upon the language "in those States"[58] in the Board's Interpretation has replaced a solution that is more in keeping with the spirit and purpose of the Truth in Lending Act with one that seems technical and against the purpose of the Act. The impact of this decision is somewhat limited. As previously indicated, only a few states allow unrestrictied use of cognovit provisions.[59] Moreover, the *Swarb* and *Overmeyer* decisions raise grave doubts as to the constitutionality of the cognovit provisions employed by Beneficial in this case and in most consumer credit transactions.

D. STEVE ROBBINS

Criminal Law—Increased Sentences on an Appeal by Right from Inferior Courts

In 1969 the United States Supreme Court held in *North Carolina v. Pearce*[1] that a criminal defendant who had successfully appealed his original conviction could not receive a more severe sentence on reconviction unless the increase directly resulted from defendant's conduct subsequent to his original conviction. The Court concluded that while there was no absolute constitutional bar to an increased sentence on retrial,[2] due process precluded penalizing a defendant for having successfully

[58]469 F.2d at 456.

[59]*See* note 54 *supra*.

[1]395 U.S. 711 (1969).

[2]"We hold, therefore, that neither the double jeopardy provision nor the Equal Protection Clause imposes an absolute bar to a more severe sentence upon reconviction." *Id.* at 723.