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Legal Counsel

MEMORANDUM

TO: Ohio Receivables Management Association

CC: Lora L. Miller, Executive Director

FROM: Bryan J. Farkas
Carrie Mae Brosius

DATE: June 8, 2019

RE: The Potential Negative Impact of House Bill 251 on Ohio's Credit Market

ISSUE PRESENTED

Identify the potential negative impact on Ohio's credit market of House Bill 251, which proposes to amend §§ 2305.06 and 2305.07 of the Ohio Revised Code by reducing the statute of limitations for causes of action arising from written and oral contracts.

SUMMARY OF FINDINGS

We believe that House Bill 251, if passed, may have several negative consequences on Ohio, including but not limited to the following:

1. House Bill 251 will most likely create a riskier credit environment for lenders by materially reducing the statute of limitations for lenders to collect on defaulted debts.
2. Lenders are likely to reduce the credit available to borrowers as well as increase the cost of obtaining credit by imposing higher interest rates and fees to borrowers.

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3. New businesses may be detracted from coming to Ohio and existing businesses may find the new credit market more challenging.
4. Lenders will be forced to file legal action against defaulting borrowers at a much faster pace.
5. The acceleration of collection actions may potentially clog and burden Ohio's court systems.
6. Lenders and borrowers will have significantly less time to negotiate out-of-court resolutions for delinquent debt.
7. Borrowers will have less time to "climb out of debt" and avoid costly legal proceedings, potentially forcing many of them to file premature bankruptcies.
8. Ohio will become only 1 of 8 states to impose a 3-year statute of limitations on written contracts (most states impose a 5- or 6-year statute of limitations).

DISCUSSION AND ANALYSIS

I. Summary of House Bill 251.

House Bill 251 proposes to amend §§ 2305.06 and 2305.07 of the Ohio Revised Code by reducing the statute of limitations for causes of action arising from written contracts from 8 to 3 years and for causes of action arising from oral contracts from 6 to 3 years. The current draft of the proposed legislation (as of the date of this Memorandum)

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states as follows:

Section 1. That sections 2305.06 and 2305.07 of the Revised Code be amended to read as follows:

Sec. 2305.06. Except as provided in sections 126.301 and 1302.98 of the Revised Code, an action upon a specialty or an agreement, contract, or promise in writing shall be brought within ~~eight~~ three years after the cause of action accrued.

Sec. 2305.07. Except as provided in sections 126.301 and 1302.98 of the Revised Code, ~~an~~ both of the following apply:

(A) An action upon a contract not in writing, express or implied, ~~or~~ shall be brought within three years after the cause of action accrued.

(B) An action upon a liability created by statute other than a forfeiture or penalty, shall be brought within six years after the cause ~~thereof~~ of action accrued.

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Section 2. That existing sections 2305.06 and 2305.07 of the Revised Code are hereby repealed.

Section 3. Subject to Section 4 of this act, sections 2305.06 and 2305.07 of the Revised Code, as amended by this act apply to an action in which the cause of action accrues on or after the effective date of this act.

Section 4. For causes of action that are governed by section 2305.06 or division (A) of section 2305.07 of the Revised Code and that accrued prior to the effective date of this act, the period of limitations shall be three years from the effective date of this act or the expiration of the period of limitations in effect prior to the effective date of this act, whichever occurs first.

II. Summary of Arguments Presented in Favor of House Bill 251.

Proponents of House Bill 251 (and its predecessor) contend that reducing the statute of limitations for contract claims will improve the business climate in Ohio. By reducing the statute of limitations, the revised law will reduce the number of years that a business will need to store and maintain its records, thereby reducing costs. The change also arguably promotes stability and financial planning for businesses. By reducing the time in which a claimant may bring a cause of action, it reduces risks and unexpected costs and allows for more effective planning. Some backers note that reducing the time in which a claimant may bring an action on a contract claim will lessen the chance that documents relevant to the action will be lost or destroyed or that witnesses will become unavailable. This, in turn, they argue improves the fairness and the efficiency of legal

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actions, thereby making Ohio a more attractive state in which to conduct business.

Proponents such as the National Federation of Independent Business in Ohio, the Ohio Chamber of Commerce, Ohio Alliance for Civil Justice and the Ohio Manufacturers' Association argue that these benefits enhance Ohio's competitiveness and allow Ohio to attract more jobs and improve Ohio's economic development.

Other supporters of the proposed bill reason that the reduction in the statute of limitations may have a positive impact on the state's judicial system. The Ohio Legislative Service Commission maintains that reducing the limitations may reduce the overall case volume and increase the number of cases dismissed in their early stages (due to plaintiffs filing outside of the statute of limitations). Thus, the proposed bill has the potential to create a "savings effect" on the state's court system.

While there is some merit to the advantages touted by the proponents of House Bill 251, we believe their analysis is short sighted. By focusing on the more immediate and direct possible advantages offered by the proposed bill, the proponents neglect to consider the likely disadvantages – some of which negatively impact the same constituents and groups the proponents represent – that will result if House Bill 251 passes.

III. The Negative Impact of House Bill 251 on the Availability and Cost of Credit in Ohio.

In extending credit, all creditors, including, but not limited to, consumer and commercial lenders, financial institutions, credit card companies and retail lenders, must

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assess their risk of loss. One element of the risk of loss is the ability to collect defaulted debts. Limiting or reducing a remedy available to a creditor negatively impacts the creditor's risk assessment for extending credit. (*See Zywicki, Todd J. "The Law and Economics of Consumer Debt Collection and its Regulation." Loy. Consumer L. Rev. 28.167 (2016).*) Reducing the period of time in which a creditor may pursue an action against a delinquent debtor most likely increases a creditor's rate of loss. In response, the creditor must either become more aggressive on an accelerated basis in collecting its loans or the creditor must sustain greater losses on defaulted loans. (*Zywicki, 183.*) Either outcome affects a creditor's bottom line; the former drives collection costs up while the latter reduces income and recovery. Further, borrowers may be more likely to default because reducing the creditor's ability to recover on a defaulted loan minimizes a borrower's risks. (*See Zywicki, 183.*)

When faced with increased risks, creditors look for ways to reduce their exposure. (*See Zywicki.*) Steps taken by creditors may include: limiting credit offered to higher-risk borrowers, lending less to the same borrowers by reducing the amount loaned, increasing fees, increasing interest rates, demanding more security, requiring larger down payments for home loans or instituting annual fees. (*See Zywicki.*) Because creditors cannot accurately predict which borrowers will default, **all** borrowers will be impacted with less availability to credit or higher costs. (*Zywicki, 184.*) It is important to note that higher risk borrowers (which typically include lower income consumers and smaller businesses) will likely fair worse than lower risk borrowers. (*Zywicki, 190.*)

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While limited benefits may result from the reduced statute of limitations (as discussed in Section II), borrowers – consumer and commercial alike – may be harmed due to less access to credit or the higher cost of available credit. For example, the same small business that benefits from having to only maintain records for 3 years instead of 8 may be harmed by having the availability on its line of credit reduced or its interest rate increased. Similarly, the consumer who defaulted on a credit card loan over 3 years ago may have certainty and need not worry about a creditor pursuing payment on this particular debt; however, the same consumer may not be able to find affordable credit available to him or her in the future or, in some instances, may not be able to find any credit.

Although there are no recent empirical studies that examine the impact of the length of the statute of limitations on credit terms and availability, the economic impact of consumer regulations has been studied on occasion over the years. Prior studies have shown that interest rates are lower when remedies are less restricted and interest rates are higher when remedies are more restrictive (Zywicki, 190, *citing* James R. Barth, et al., “The Effect of Government Regulation on Personal Loan Markets: A Tobit Estimation of a Microeconomic Mode”, *J. Fin.* 38.1233 (Sept. 1983).) A study was conducted after the enactment of the Wisconsin Consumer Act (“WCA”), which imposed several new limits on the remedies available to creditors of consumer debt. (Zywicki, 191, *citing* William C. Dunkelberg, “Banks Lending Response to Restricted Creditor Remedies” (Credit Research Ctr. Working Paper No. 20 (1978).) Of the banks surveyed, 46% of them

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changed their lending practices as a result of WCA. (Zywicki, 191.) Changes included tightening credit standards, making fewer loans to marginal borrowers, restricting loan maturities, limiting the type or the size of the loans available and increasing interest rates, fees or other costs. (Zywicki, 191.) In some instances, banks stopped making smaller loans all together because WCA increased collection costs.¹ (Zywicki, 191.) A more recent study showed that stricter regulations of third-party debt collectors resulted in a lower level of credit card collections and subsequently led to a decrease in the number of new revolving lines of credit for consumers. (Zywicki, 193, *citing* Viktor Fedaseyeu, “Debt Collection Agencies and the Supply of Consumer Credit” (Fed. Reserve Bank of Phila., Working Paper No. 13-38, 2013).) In summary, prior studies of regulations that restrict lenders’ collection efforts indicate that an amendment that curtails the time in which creditors may pursue collection actions will generate a negative impact on the affected credit market.

Reducing the statute of limitations increases the risks borne by creditors.

Accordingly, to compensate for the increased risks, creditors are likely to react by limiting the credit available to borrowers (particularly higher risk borrowers) and/or increasing the cost of credit through increased interest rates, fees and/or costs. Such a

¹ The cost of servicing a delinquent loan typically does not vary with the size of the loan – generally, it costs the same to collect a \$2,000 loan as it would a \$20,000 loan. For smaller loans, the collection costs can exceed the recovery and it becomes uneconomical for the bank to pursue collection when borrowers default. As collection costs increase, more loans fall into the category where it becomes inefficient to exercise collection efforts. Rather than bear the heightened risks, some banks may stop making small loans to riskier borrowers.

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result harms both Ohio's consumers and businesses – and would detract new businesses from coming to Ohio and create a more challenging financial environment for Ohio's existing businesses.

IV. The Negative Impact of House Bill 251 on Ohio's Court System.

Reducing the time in which a creditor may commence a collection action is likely to increase the costs and burden on Ohio's court system. Minimizing the time in which creditors may act will reduce creditors' ability and/or willingness to engage in out of court resolutions. Creditors will have less time to work with borrowers prior to filing a complaint. Some creditors, in an effort to avoid a statute of limitations issue, will accelerate their collection process, rely less on out of court collection efforts and file more collection actions sooner, thereby increasing the courts' caseloads. Similarly, constrained by time limits, creditors and debtors will have less of an opportunity to enter into a forbearance or a debt restructuring or refinancing arrangement, also resulting in more collection cases being filed with the courts.

At this stage, it is difficult to place a dollar value on how the proposed bill will influence Ohio's court system. However, it is clear that House Bill 251 may lead to an undesirable outcome. With less time to pursue out of court collection efforts or to work with borrowers and negotiate out of court workouts (i.e., forbearance or refinancing arrangements), creditors are likely to file more collections actions and within a short timeframe following an event of default. Accordingly, rather than creating a cost savings

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effect, House Bill 251 may very well impose a greater burden and cost on Ohio's court system.

V. Other Negative Consequences of House Bill 251.

Significantly reducing the time in which creditors may pursue collection actions against defaulting debtors may generate some outcomes that over time may be difficult to quantify but will be no less harmful. A few examples are discussed briefly below.

The reduction of the statute of limitations will likely adversely affect third party debt buyers in Ohio. Banks often minimize their losses and reduce their risks by selling their debt to third parties, particularly their nonperforming debt. Cutting short the ability to collect delinquent debt will shrink the market for third party loan sales. Reducing the number of loans that can be sold to third parties may bring about several negative consequences. First, it reduces a lender's ability to minimize its losses and reduce its risk. Second, as discussed above, when a lender's risks are adversely affected it often responds by increasing the price of credit or reducing the availability of credit. Lastly, third party debt buyers employ individuals and engage the services of various professionals to aid in debt collection. With fewer loans being purchased, the third-party debt buyer industry may very well shrink, along with Ohio jobs in this industry.

With creditors taking a more aggressive approach to collections and truncating out of court workouts, the number of bankruptcy filings may increase as well. Such a result not only increases the case load of the federal bankruptcy court system, it will also cause a negative ripple effect on Ohio's credit providers. When one defaulted loan

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causes a bankruptcy, it triggers a default on all of a borrower's loans. Thus, where only one creditor of a borrower may not have received payment in full outside of bankruptcy, once a bankruptcy is filed, all of the borrowers' unsecured creditors end up with little to no recovery on their debts.

VI. Aligning Ohio with the Majority of States.

Proponents argue that House Bill 251 will make Ohio more competitive with other states. However, 29 out of the 50 states plus the District of Columbia impose a 5- or 6-year statute of limitations on written contract claims, with 22 states favoring a 6-year statute of limitations. Only 8 states impose a 3-year statute of limitations and 3 states impose a 4-year statute of limitations on claims arising out of written contracts, while Ohio is only 1 of 10 states that imposes statute of limitations of 8 years or more on written contracts. Reducing Ohio's statute from 8 to 3 years will cause Ohio to go from one extreme to another.²

CONCLUSION

If passed, House Bill 251 may have several negative consequences on Ohio. First, it will most likely create a riskier credit market in Ohio. Second, lenders are likely to reduce access to credit and/or increase the cost of credit by imposing higher interest rates and/or fees to businesses and other borrowers. Third, new businesses may be

² 20 out of 50 states impose a 5- or 6-year statute of limitations for claims arising out of oral contracts. Thus, a similar argument could be advanced for maintaining Ohio's current 6-year statute of limitation for claims arising from oral contracts. Notably though, 16 states impose a 3-year statute of limitations for claims arising out of oral contracts and another 9 states impose a 4-year statute of limitations for such claims. Thus, this argument is not as strong for oral contracts as it is for written contracts.

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deterred from coming to Ohio and existing businesses will find Ohio's new credit market more difficult. Fourth, lenders will be compelled to file legal action against delinquent borrowers at a much faster pace. Fifth, the acceleration of such collection actions may overburden Ohio's court systems. Sixth, lenders and borrowers will have less time to negotiate out of court settlements. Seventh, delinquent borrowers will have less time to restructure their debts and avoid costly legal proceedings, potentially forcing a number of them to file premature bankruptcies. Finally, Ohio will become only 1 of 8 states to impose a 3-year statute of limitations on written contracts.