NOTES

Creditor's Counterclaim for Underlying Debt in Default is a Compulsory Counterclaim in Truth in Lending Action

In *Plant v. Blazer Financial Services, Inc.*,[1] the Fifth Circuit Court of Appeals held that an action on an underlying debt in default was a compulsory counterclaim within the meaning of Federal Rule of Civil Procedure 13(a), which must be asserted in a Truth in Lending action by a debtor.[2] The court also held that traditional rules of set off were applicable to the award of actual damages and the statutory recovery mandated by the Truth in Lending Act, but the award of fees to the debtor's attorney could not be subjected to the creditor's right of set off.[3] This decision resolved an issue which had divided lower federal courts throughout the Fifth Circuit, and indeed, throughout the country. It is the first such decision by any federal appellate court.

In June of 1975, Plant executed a promissory note in favor of Blazer Financial Services for approximately $2500. This action was commenced by Plant some months later for recovery for nondisclosure violations of the Truth in Lending Act;[4] specifically, a violation of section 1640 was alleged.[5] Defendant-creditor, Blazer Financial Services, instituted a coun-

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1. 598 F.2d 1357 (5th Cir. 1979).
2. *Id.* at 1358.
3. *Id.*
4. 15 U.S.C.A. §§ 1601-65 (1974)(current version at 15 U.S.C. §§ 1601-67e (1976 & Supp. 1978).
5. The statute reads in pertinent part:

> Except as otherwise provided in this section, any creditor who fails in connection with any consumer credit transaction to disclose to any person any information required under this part to be disclosed to that person is liable to that person is an amount equal to the sum of (1) twice the amount of the finance charge . . ., except that the liability under this paragraph shall not be less than $100 nor greater than $1,000; and (2) in the case of any successful action to enforce the foregoing liability, the costs of the action together with a reasonable attorney's fee as determined by the court.

terclaim for the unpaid balance due on the promissory note executed by Plant, alleging that no payments had been made thereon. The District Court for the Northern District of Georgia, relying on the en banc decision of that court in *Mims v. Dixie Finance Corp.*,[6] held that the creditor's counterclaim was compulsory and proceeded to render a judgment for plaintiff on the Truth in Lending claim, and for defendant on the counterclaim for the defaulted debt.[7]

Plaintiff was awarded $944.76 as statutory damages and $700 as attorney fees in accordance with section 1640 of the Act. This total award was then offset by the trial court against the judgment for defendant on the counterclaim. The case came to the Fifth Circuit on plaintiff's appeal which alleged that the trial court lacked jurisdiction to entertain the counterclaim, and that the offset of the award for reasonable attorney fees was reversible error.[8]

The challenge by plaintiff to the jurisdiction of the trial court was based on the assertion that the defendant-creditor's counterclaim was a permissive counterclaim within the meaning of Federal Rule of Civil Procedure 13(a). That rule provides: "A pleading *shall state* as a counterclaim any claim which . . . the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim. . . ."[9] When the counterclaim is characterized as permissive, an independent ground of federal jurisdiction over the counterclaim must exist, for example, federal question or involves diversity of citizenship. In the absence of an independent ground of jurisdiction, the federal courts, as courts of limited jurisdiction, are without power to adjudicate the counterclaim.[10] In contrast, a counterclaim which is found to be compulsory is said to be within the ancillary jurisdiction of the federal courts and may be entertained even in the absence of an independent jurisdictional basis.[11] A failure to plead a compulsory counterclaim may result in a subsequent action being barred by the doctrine of res judicata.

The purpose of Rule 13 is to allow the court broad discretion in order to resolve all controversies between the parties in a single suit, and to

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15 U.S.C.A. § 1640(a)(1974)(current version at 15 U.S.C. § 1640(a)(1976)).

6. 426 F. Supp. 627 (N.D. Ga. 1976), *overruling* Roberts v. National School of Radio & Television Broadcasters, 374 F. Supp. 1266 (N.D. Ga. 1974).

7. 598 F.2d at 1359.

8. *Id.* Plaintiff also asserted defenses to the counterclaim under Georgia law.

9. FED. R. CIV. P. 13(a)(emphasis added).

10. Diamond v. Terminal Ry. Ala. State Docks, 421 F.2d 228, 236 (5th Cir. 1970). *Accord*, Autographic Register Co. v. Philip Hano Co., 198 F.2d 208, 212 (1st Cir. 1952). *See also* 3 MOORE'S FEDERAL PRACTICE ¶ 13.19 (2d ed. 1979).

11. Baker v. Gold Seal Liquors, Inc., 417 U.S. 467, 469 n. 1 (1974). *See also* Revere Copper & Brass, Inc. v. Aetna Cas. & Sur. Co., 426 F.2d 709, 714-15 (5th Cir. 1970).

avoid the inefficiencies of multiple litigation.[12] "The objective of the Federal Rules with respect to counterclaims is to provide complete relief to the parties, to conserve judicial resources and to avoid the proliferation of lawsuits."[13] To accommodate the need for discretion, the courts have chosen not to define precisely the meaning of the same "transaction or occurrence" test of Rule 13(a). Rather, four subtests have generally been used to analyze this issue: "(1) Are the issues of fact and law raised by the claim and the counterclaim largely the same? (2) Would res judicata bar a subsequent suit on defendant's claim absent the compulsory counterclaim rule? (3) Will substantially the same evidence support or refute plaintiff's claim as well as defendant's counterclaim? (4) Is there any logical relation between the claim and the counterclaim?"[14]

In previous decisions construing Rule 13 the Fifth Circuit has expressed a preference for the last of these tests, the so-called "logical relationship" test.[15] In *Revere Copper & Brass, Inc. v. Aetna Casualty & Surety Co.*,[16] the court stated that the required nexus would be said to exist

> where separate trials on each of their respective claims would involve a substantial duplication of effort and time by the parties and the courts. Where multiple claims involve many of the same factual issues, or the same factual and legal issues, or where they are offshoots of the same basic controversy between the parties, fairness and considerations of convenience and of economy require that the counterclaimant be permitted to maintain his cause of action. . . .[17]

It is interesting to note that many of the district courts that have decided the issue of whether a creditor's counterclaim is a compulsory one in an action by a debtor for a Truth in Lending violation have used these same four tests.[18]

The decision whether this type of counterclaim is to be held permissive or compulsory must be considered in the context of the peculiar nature of

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12. *See* Comment, 28 CASE W. RES. L. REV. 434 (1979).

13. Montecatini Edison, S.P.A. v. Ziegler, 486 F.2d 1279, 1282 (D.C. Cir. 1973).

14. 6 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1410, at 42 (1971).

15. *See, e.g.*, Revere Copper & Brass, Inc. v. Aetna Cas. & Sur. Co., 426 F.2d 709, 714 (5th Cir. 1970).

16. *Id.* at 709.

17. *Id.* at 714 (citations omitted).

18. *See, e.g.*, Zeltzer v. Carte Blanche Corp., 414 F. Supp. 1221 (W.D. Pa. 1976) (permissive); Ball v. Connecticut Bank and Trust Co., 404 F. Supp. 1 (D. Conn. 1975)(permissive); Meadows v. Charlie Wood, Inc., 448 F. Supp. 717 (M.D. Ga. 1978) (permissive); Roberts v. National School of Radio & Television Broadcasting, 374 F. Supp. 1266 (N.D. Ga. 1974) (permissive), *overruled*, Mims v. Dixie Fin. Corp., 426 F. Supp. 627 (N.D. Ga. 1976) (en banc); Carter v. Public Fin. Corp., 73 F.R.D. 488 (N.D. Ala. 1977)(compulsory).

the Truth in Lending Act. The purposes of the Act are set forth clearly in the Act itself: "It 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."[19] The statute does not seek to invade the area of regulation of credit, which is properly a state function. Rather, the basic goal of the Act is disclosure of specified terms in a specified manner, and it is nondisclosure which is the subject of penalty. To accomplish this goal the individual debtor is said to stand in the position of a "private attorney general."[20] This intent is evidenced in the Act's provisions which mandate minimum and maximum statutory damages in addition to, or in the absence of, actual damages incurred by the individual.[21]

As has been previously noted, prior to the Fifth Circuit's decision in this case, only the lower federal courts had addressed the counterclaim question. *Roberts v. National School of Radio & Television Broadcasting*[22] was the first district court decision on the issue and was subsequently relied on by other district courts. In that case, plaintiff-student alleged that defendant trade school had failed to describe adequately the credit terms of a note the student had executed. The court held defendant's counterclaim to be permissive and refused to entertain it. Although the court seemingly applied the traditional four part test, essentially the characterization of the counterclaim as permissive was the result of policy considerations; specifically, the court was unwilling to "unduly complicate the expeditious resolution of TIL litigation."[23]

Other courts have also expressed concern that the effectuation of the policy of the Truth in Lending Act would be endangered by holding counterclaims on the underlying debt to be compulsory. In *Zeltzer v. Carte Blanche Corp.*,[24] the court noted that although the counterclaim appeared to be compulsory, important policy considerations signalled caution. The court went on to hold that, although on a purely transactional level a logical relationship could be said to exist, a stricter analysis revealed that the claims raised entirely separate legal issues and distinct factual issues, and were not the same controversy. The counterclaim was characterized as permissive and dismissed.[25]

This is typical of the analysis used by the district courts; indeed, as the

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19. 15 U.S.C.A. § 1601 (1974)(current version at 15 U.S.C. § 1601(a)(1976)).
20. Ratner v. Chemical Bank New York Trust Co., 329 F. Supp. 270, 280 (S.D.N.Y. 1971).
21. 15 U.S.C.A. § 1640(a)(1974)(current version at 15 U.S.C. § 1640(a)(1976)).
22. 374 F. Supp. 1266 (N.D. Ga. 1974).
23. *Id.* at 1271.
24. 414 F. Supp. 1221 (W.D. Pa. 1976).
25. *Id.* at 1224.

Fifth Circuit recognized, the majority of the district courts have similarly characterized these counterclaims as permissive.[26] As one court has stated, "[A]ny perceived logical nexus is conceptual, abstract, a formal characterization rather than a recognition of concrete advantage to be achieved through single forum adjudication of all the parties' opposing claims."[27] This argument of illusory gain in judicial economy has been stressed in several cases.[28]

There are many cases which have characterized the creditor's action as a compulsory counterclaim, and frequently these courts have expressed exasperation with their brethren who would hold otherwise. As one court said in criticism of the application of the four above mentioned tests: "The only thing that matters is that they arose out of the same transaction. The rule plainly says this!"[29]

Perhaps the most important decision characterizing a creditor's counterclaims as compulsory was the en banc decision of the District Court for the Northern District of Georgia in *Mims v. Dixie Finance Corp.*[30] In overruling its previous decision in *Roberts*, the court deferred to a great extent to the recommendation of the special master that the counterclaim be held compulsory. The court first considered whether the counterclaim would be characterized as compulsory under the traditional tests. The court found that under this form of analysis the counterclaim was indeed compulsory. Next, the court considered whether public policy considerations should disallow the counterclaim. It was found that policy considerations did not require that an exception to the compulsory counterclaim rule be created.[31]

Following the lead of the *Mims* court, the Fifth Circuit also used a two step process in its analysis of the issue. First, the court applied the traditional tests used to determine the question of whether a counterclaim was compulsory within the meaning of Rule 13, once again expressing its preference for the "logical relationship test." Relying primarily on *Revere Copper & Brass,*[32] the court stated that the required nexus was present when the same "aggregate of operative facts" gave rise to both claims.[33] On the present facts, application of this test was found to indicate clearly the compulsory nature of the counterclaim "because a single aggregate of

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26. 598 F.2d at 1361.

27. Ball v. Connecticut Bank & Trust Co., 404 F. Supp. 1, 4 (D. Conn. 1975).

28. *See, e.g.*, Zeltzer v. Carte Blanche Corp., 414 F. Supp. 1221, 1225 (W.D. Pa. 1976); Agostine v. Sidcon Corp., 69 F.R.D. 437, 442 (E.D. Pa. 1975).

29. Carter v. Public Fin. Corp., 73 F.R.D. 488 (N.D. Ala. 1977).

30. 426 F. Supp. 627 (N.D. Ga. 1976).

31. *Id.* at 630.

32. 426 F.2d 709 (5th Cir. 1970).

33. 598 F.2d at 1361.

operative facts, the loan transaction, gave rise to both plaintiff's and defendant's claim."[34] The court disregarded dicta by a previous panel of the Fifth Circuit in *Spartan Grain & Mill Co. v. Ayers*,[35] to the effect that such a claim was permissive.

The court then proceeded to the second stage of its analysis, an analysis of the policies underlying Rule 13(a) and the Truth in Lending Act, a step necessitated by the realization that the majority of district courts had reached a contrary result and held the claim to be permissive.[36] The Fifth Circuit acknowledged the concerns expressed by the district courts: that the enforcement of Truth in Lending claims would be endangered; that the federal courts would be deluged by debt counterclaims; that the manageability of class actions might be destroyed by interjecting individual questions; and that the balance between the state and federal judiciary would be disturbed.[37] Nevertheless, the court held the counterclaim to be compulsory.

Several district court opinions refuting these fears were cited; apparently most persuasive to the court was *Mims*. Approval was expressed for the notion that "the federal judiciary should not reallocate litigation burdens for public policy reasons without legislative guidance."[38] Also, the court agreed with the court in *Mims* that no significant additional burden would be placed on the judge, because the only additional fact required to be proved in the action on the counterclaim was the amount of the debt already paid.[39]

Finally, in support of its holding, the court relied upon the Act's procedural mechanism of allowing a claim to be brought in state or federal court.[40] The court inferred from this grant of concurrent jurisdiction that Congress intended that counterclaims be actionable in federal court, since such counterclaims were obviously enforceable in state courts.[41]

The Fifth Circuit further held that an award of attorney fees was not subject to set off against the debtor's outstanding debt to the creditor.[42] The claim of defendant that the award was personal to plaintiff rather than to his attorney, and therefore should be subject to set off, was re-

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34. *Id.*

35. 581 F.2d 419 (5th Cir. 1978). It should be noted that *Spartan* involved a procedural setting opposite from this case, i.e., a Truth in Lending claim asserted in state court in an action on a debt. For a discussion of this issue *see generally*, Comment, *Truth in Lending and the Statute of Limitations*, 21 VILL. L. REV. 904 (1976).

36. 598 F.2d at 1361.

37. *Id.* at 1361-63.

38. *Id.* at 1364.

39. *Id.*

40. 15 U.S.C.A. § 1640(e)(1974)(current version at 15 U.S.C. § 1640(e)(1976)).

41. 598 F.2d at 1361-63.

42. *Id.* at 1365.

jected as favoring form over substance. Allowance of attorney fees was found to be a near necessity to the debtor's securing adequate legal representation, and therefore essential to the enforcement scheme of the Act.[43]

It cannot be said that the Fifth Circuit did not recognize and give consideration to the potential dangers involved in this decision. However, each of the possible adverse effects set forth in the court's opinion have weighed more heavily in decisions by the lower federal courts. In essence, the court found those considerations insufficient to negate what the court termed the "obvious interrelationship" of the two claims.

In fact, a debtor's claim for relief under the Truth in Lending Act for disclosure violations and a creditor's action for the underlying debt do arise from the same transaction or occurrence. The Fifth Circuit, therefore, was correct to refuse the suggestion that the act of disclosure and the credit extension were two individual transactions.[44] However, this does not resolve the question of whether the policies of either Rule 13(a) or the Truth in Lending Act were served by this decision.

The purpose of Rule 13(a) is to promote judicial economy, and there is doubt as to whether this goal will be served by the characterization of the creditor's counterclaim as compulsory. Providing complete relief to a creditor brought involuntarily into federal court is, of course, a primary concern.[45] But it should be noted that whatever advantage gained by the creditor may be offset by the more than minimal inconvenience that may result to the federal judiciary. Different evidentiary requirements are one example of this. While a debtor must prove a very limited set of facts—in many cases only statutory nondisclosure—the creditor has a much greater burden. He must prove the existence and validity of the contract, its terms, and the facts of default.[46] Also, a creditor may be entitled to a jury trial while ordinarily a debtor is not.

If then the goal of Rule 13(a) is to provide for judicial economy, to the courts as well as the parties, that goal may well be disserved by the Fifth Circuit's decision in *Plant*. Apparently the court felt that whatever additional burdens might be placed on the federal judiciary, these possibilities were not enough to overcome the advantage to the creditor in having a single adjudication of the two claims.

The dangers to the Truth in Lending Act are not so easily dismissed.[47] By exposing delinquent debtors to counterclaims, the court may have se-

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43. *Id.* at 1366.

44. *See* Comment, *Truth in Lending Act—Defendants Debt Counterclaim—Compulsory or Permissive?*, 28 CASE W. RES. L. REV. 434, 451 (1979).

45. 598 F.2d at 1364.

46. 69 F.R.D. at 442.

47. *See* Comment, *Truth in Lending Act—Defendants Debt Counterclaim—Compulsory or Permissive?*, 28 CASE W. RES. L. REV. 434 (1979).

verely limited the reach and impact of the Act. The private enforcement scheme of the Act may be curtailed. Other courts have expressed concern that consumers will have no incentive to bring a Truth in Lending suit if they could be characterized as in default. Indeed, in the *Mims* decision, the court for the Northern District of Georgia expressed the view that a reduction in litigation would result since many plaintiff-debtors are in default, and the court apparently did not find this an undesirable result of its decision![48]

An additional consideration is the impact of the decision on potential class actions. Such actions are a primary means of enforcement of the nondisclosure penalty provisions of the Act. However, by holding a counterclaim by a creditor to be compulsory, the court very much endangers this procedure. This characterization leads to the inevitable conclusion that the potential class members have divergent interests, and thus that the class is unmanageable within the meaning of Federal Rule of Civil Procedure 23.[49] A court would be justified in excluding potential class members who were in default, or in denying class standing altogether.

Basically the issue that faced the Fifth Circuit was whether an exception to Rule 13(a) should be created in light of the concerns expressed above. Obviously, there are potential adverse effects. However, the court did consider these dangers and found it could not fashion such an exception. This, the court stated, was a legislative function. And it does not seem quite fair that a creditor should be able to get complete relief in a state court and be foreclosed from such relief in the federal courts.

The allowance of the set off of statutory damages will also have an impact on Truth in Lending litigation because the debtor might not be rewarded with cash in hand. Of course, these statutory damages are intended as a penalty for nondisclosure rather than a remedy to make the debtor whole for any actual damages he may have suffered. The deterrent purpose of the Act will still be accomplished; however, once again, debtors may have less incentive to assert a claim for Truth in Lending violations.

Although the Fifth Circuit did not regard the receipt of a monetary award by the debtor as essential to the enforcement scheme of the Act, the court did not allow a set off against the award of attorney fees to a successful plaintiff because of the realization that many potential claimants would be unable to secure legal representation without this award. Cynics may argue that the court's decision reflects a philosophy that while attorneys are necessary for the enforcement of the policies of the

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48. 426 F. Supp. at 630.

49. George v. Beneficial Fin. Co. of Dallas, 81 F.R.D. 4 (N.D. Tex. 1977); Carter v. Public Fin. Corp., 73 F.R.D. 488 (N.D. Ala. 1977).

Act, plaintiffs are not.

In view of the language of Rule 13(a), the Fifth Circuit felt it had little choice but to characterize a creditor's counterclaim for an underlying debt in default as a compulsory counterclaim. It remains to be seen how the other federal appellate courts will respond to this issue. It remains also to be seen whether the fears expressed by so many of the district courts will be realized. Seemingly, the Truth in Lending Act will survive as an effective means of promoting disclosure to consumers. It must be noted that the *Plant* decision will affect and apply only to debts in default. If the Congress is displeased with the effects of this decision, it can provide through legislation a remedy which the Fifth Circuit would not.

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