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**AN INVESTIGATION OF DEBT SETTLEMENT COMPANIES:
AN UNSETTLING BUSINESS FOR CONSUMERS**

A Report by the National Consumer Law Center
March 2005

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INTRODUCTION AND METHODOLOGY

Many states as well as the National Conference of Commissions on Uniform State Laws (NCCUSL) have attempted to regulate debt settlement through laws that mainly target debt management practices. In fact, debt management and debt settlement are very different businesses. By including debt settlement in laws that focus on debt management, policymakers are helping to legitimize debt settlement—a business model that is inherently harmful to consumers.

This report is a first step at shedding some light on the debt settlement industry and explaining the differences between debt settlement and debt management. The information in this report is based on a survey of thirteen debt settlement companies conducted from January through March 2005, including phone interviews and information collected from company web sites. We also used information from a previous survey, including numerous debt settlement company enrollment agreements, collected in 2003 and 2004. In addition, we compiled information from Better Business Bureau complaints, government enforcement actions and receiver reports, media reports, and information from private lawyers.

Our requests for information from the United States Organizations for Bankruptcy Alternatives (USOBA) were initially ignored and we did not receive any information in time to use for this report. In addition, many debt settlement companies we called would not share information about their business. This reluctance to provide information should be seen as a huge warning sign. Clearly subsequent reports would benefit from information provided by the industry itself.

DIFFERENCES BETWEEN DEBT MANAGEMENT AND DEBT SETTLEMENT

Unlike most credit counseling agencies, debt settlement and debt negotiation companies are usually for-profit businesses. Settlement services are different from debt

management mainly because the debt settlement companies do not send regular monthly payments to creditors. Instead, these agencies generally maintain a consumer's funds in separate accounts, holding the money until the company believes it can settle the consumer's debts for less than the full amount owed. Many companies advise consumers to stop paying their debts as a condition of participation in the program.

Nearly all companies have a minimum debt requirement. Of our survey of thirteen debt settlement companies, nine specifically stated a minimum amount of debt required for the program. These amounts ranged from \$5,000 to \$10,000. All of the programs handle unsecured debt only.

The companies have different ways of doing business, but nearly all of them require the consumer to set aside money each month. Sometimes the settlement company will set up an account for the consumer. In other cases, they will ask the consumer to show proof of an account. They will almost always figure out a way to take their fees directly from the account.

The companies require the consumer to deposit a certain amount in the account each month. This is intended to build up a fund that can later be used to try to settle debts. In the meantime, the consumer does not make payments on her debts. This means that she could be sued for collection or face pressure from debt collectors. The ways in which companies assist or don't assist consumers with these collection efforts are discussed in detail below.

The Better Business Bureau summarizes the business model as follows: Debt settlement companies "...usually instruct their clients to stop paying their creditors. Some companies direct them to make their payments to the debt negotiation company instead and promise, when the company has accumulated enough to offer a cash settlement to one or more creditors (which can take as long as two or three years) to pay off the debt. The debtor must pay fees to the service during the time the payments are accumulating. Other companies simply collect the fees and advise debtors to save their money to pay their creditors themselves."¹

Another key difference occurs with respect to the laws that cover debt settlement companies. Because most debt settlement companies are for-profit businesses, they are not exempted from numerous consumer protection laws that exempt non-profits.² This report includes detailed information about numerous existing laws that cover debt settlement companies (and in some cases debt management as well). The recommendations section contains proposals for improving existing laws and crafting stronger, more targeted debt settlement laws.

¹ See, e.g., Better Business Bureau Company Report on Prosper Financial Solutions, San Clemente, CA. Available at www.labbb.org (last accessed on February 15, 2005).

² Non-profits that are for-profits in disguise should also not get the benefit of these exemptions.

KEY PROBLEMS WITH DEBT SETTLEMENT

Overview

In a 2004 phone discussion, Robert Lemelin, then co-chairman of the National Association of Consumer Debt Settlement Companies, explained that only a subset of consumer debtors that cannot benefit from debt management are likely to benefit from debt settlement.³ The “ideal” customers, he said are insolvent, unable to afford the minimum payments required by a debt management plan (DMP), but have the ability to pay something.

There is likely a subset of consumer debtors who meet this profile. However, it is unlikely that this is a very large group. Most consumer debtors have less income than expenses each month or they wouldn't be in financial trouble. Some, with budget counseling or other assistance, are able to squeeze out some additional money from their budgets each month. Most likely some of these consumers are unable to qualify for a DMP. The question is whether this subset of debtors who have only a small amount of money left over each month after paying necessary expenses can benefit from debt settlement. As discussed in detail below, we believe that the business model used by most debt settlement companies is unlikely to help even this subset of debtors.

The main problems with debt settlement are:

- The consumers targeted by debt settlement companies are generally the least likely to benefit.
- Very few consumers ever complete a debt settlement program. Settling multiple debts, if it ever occurs, is a very long process. In the meantime, consumers in debt settlement programs continue to face collection efforts. Their debts also continue to grow as creditors pile on fees and interest accrues.
- Debt settlement fees are so high that the consumers don't end up saving much in the so-called “reserve accounts.”
- It is unclear what if any professional services most debt settlement companies offer to assist debtors during the time they are saving money for settlement.

³ July 2004 phone call with Robert Lemelin, Deanne Loonin NCLC), Travis Plunkett and Anna Petrini, (CFA).

The Industry’s “Ideal” Customers Are The Least Likely to Benefit

Debt settlement companies have described the ideal debt settlement customer as someone who is suffering from a hardship of some kind and having difficulty making payments, with past due credit card debt of a minimum amount, irresolvable debt problems, trouble staying current, and delinquent on accounts or close to having judgments filed against them, considering bankruptcy but prefer to avoid it and cannot afford to pay their debts.

Some companies will work only with insolvent customers, defined in some cases to mean consumers who are unemployed. Others require that the consumer be in a hardship situation. One company states that its program is appropriate for consumers with little or no ability to pay their debts and facing possible bankruptcy. “It is not for people who are gainfully employed or have high credit ratings.” Another company strongly discourages people with good credit.

The problem is that unemployed, insolvent consumers are the least likely to be able to afford the hefty monthly payments and other administrative fees. Further, even though these consumers can be severely affected by collection harassment and by damage to their credit ratings, they are generally less vulnerable to creditor efforts to collect judgments. This is because many of these consumers are “judgment proof.” A simple cease communication letter is all many of these consumers need to stop collection efforts, not an exorbitantly priced program that is unlikely to alleviate their debt problems.

The “judgment proof” issue is critical. NCLC and other experts who have worked with low-income consumers for years agree on at least the following advice to consumer debtors: 1) Consumers should focus on paying high priority, usually secured debts first; and 2) The consequences of not paying unsecured debt vary significantly depending on whether the consumer is judgment proof. Yet throughout our investigation of debt settlement companies, not a single representative has told us that they screen to see whether a customer is “judgment proof.” Arguably, it would not be appropriate in any case for these companies to conduct such a screening since it would likely be considered the practice of law. However, the non-lawyer debt settlement companies could and should at least refer customers to legal counsel for an assessment of the consumer’s vulnerability to collection.

Few Consumers Complete Debt Settlement Programs

Nearly all of the companies state that the ideal customer will have multiple debts. Debt settlement companies settle debts for customers, if at all, one debt at a time. The problem is that it takes years for a debtor in a hardship situation with multiple debts to ever set aside sufficient funds to settle all debts. In the meantime, the consumer continues to face collection tactics, compounding fees and interest and delinquencies on their credit reports.

A receiver's report on National Consumer Council (NCC) and affiliates documents this concern. NCC admitted to the receiver that at least three months were usually required to pay off the initial establishment fee and accumulated monthly fees. They also conceded that their assumption was that creditors were more willing to compromise after 6 or 7 months delinquency.⁴ The statistics compiled by the receiver showed that a mere 1.4% of the consumers that entered the program completed it. Forty-three percent cancelled after incurring fees.⁵ A principal at NCC described the settlement process as a "fire walk" for consumers that lasts 36 to 42 months.

Advising Consumer Not to Pay Debts: The Consequences for Consumers

Some companies openly admit that they advise customers to stop paying their debts. One company representative explained that making payments undermines the position of the negotiator, negatively interferes with the process and that the consumer should be saving money for settlement. One law firm debt settlement company in its initial letter to clients reminds them, "Do not send your creditors any money." They explain that this interferes with the entire process.

Others clearly imply that consumers should stop paying. For example, one company representative told us that they can't tell consumers not to pay creditors, but this is what consumers need to do because the longer they're not paying the creditors, the better deal they will eventually get from creditors. According to the representative, after twelve months of not paying and not talking to creditors, they will feel that some money is better than none.

In a 2004 lawsuit against Better Budget, the FTC alleged that the defendants tell consumers to stop paying their creditors because failure to pay will demonstrate a "hardship" condition that will enable the settlement company to negotiate.⁶ The BBB in issuing a general warning about debt settlement companies states that these companies usually instruct their clients to stop paying their creditors.⁷

⁴ Robb Evans and Associates, LLC, "Report of Temporary Receiver, May 3, 2004-May 14, 2004, First Report to the Court."

⁵ Id.

⁶ FTC v. Better Budget Financial Services, Inc., Case No. 04-12326 (D. Mass. Complaint filed November 2, 2004). Ex parte TRO with asset freeze entered November 3, 2003; Stipulation modifying and extending the TRO, November 18, 2004.

⁷ See, e.g., Better Business Bureau Company Report on Prosper Financial Solutions, San Clemente, CA. Available at www.labbb.org (last accessed on February 15, 2005).

Consequences of Not Paying

Perhaps even more serious than advising consumers not to pay their debts is the failure of many debt settlement companies to assist consumers with the consequences. It should not surprise anyone that a consumer that stops paying credit card debts is likely to face debt collection harassment and in many cases collection lawsuits. In fact, debt settlement company advertisements play heavily on these themes, in many cases sounding much more like companies that stop collection harassment rather than settle debts. Many companies highlight stopping collection calls as the first item in a list of company services

There are many problems with these claims. First, many companies do not follow through. Some simply give the consumer a packet of information that includes a cease communication letter. The consumer is on his own. Others provide limited assistance, but in fact, are not much help when serious trouble occurs. This is on one hand because most debt settlement personnel are not lawyers and should not be in the business of giving out individualized legal advice to consumers in any case. Even those that are lawyers rarely (and not in any cases that we found) represent clients that get sued or face serious collection tactics.

A second, serious problem is that not all collection tactics can be stopped once a consumer is delinquent. This is because on one hand, the federal fair debt collection law and most state laws cover third party debt collectors only.⁸ A creditor collecting its own debts is not required to comply with the federal fair debt law. This is not an open invitation to abuse because other legal claims may apply. However, the debt settlement companies focus almost exclusively on the fair debt laws, which do not apply in all cases. In addition, even if collection calls are stopped, debtors can still be sued.

The FTC summarized these problems in its May 2004 lawsuit against National Consumer Council and affiliates.⁹ According to allegations in this lawsuit, “Consumers find out, only after enrolling in defendants’ debt negotiation process that: a) even after they execute powers of attorney authorizing defendants to represent them in dealing with creditors, they are still called, harassed, and sued by their creditors for collection of their outstanding debts; b) it is not realistic for them to successfully complete the program or eliminate their debts because of intervening creditor collection efforts; c) they will continue to accrue late fees, penalties, and interest on their debt during the time they are enrolled in the debt negotiation process, even though they are making monthly payments to defendants; d) their creditors may raise the interest rates applicable to their debt because, while they are enrolled in the debt negotiation program, the creditors are not receiving the consumers’ minimum monthly debt payments; and e) defendants will not

⁸ 15 U.S.C. §1692a (definition of “collector”).

⁹ FTC v. National Consumer Council et al., SACV 04-0474 (C.D. Ca., complaint filed April 23, 2004).

reach a settlement, if at all, with the consumer's creditors, and in fact typically will not even contact the creditors, until after the consumer has deposited enough money into his NCC trust account to make a lump sum payoff to the creditors, which often does not occur until many months after the consumer has enrolled in the program."

In its lawsuit against Better Budget, the FTC alleged that rather than negotiating with creditors, the defendant in numerous instances failed to contact creditors and debt collectors.¹⁰ Consumers enrolled in the program were still contacted by creditors.

As noted by the BBB, "However the company operates, complainants allege that creditors continue to harass them, fees and interest continue to accumulate, the companies do not contact the creditors, creditors increase their collection efforts and sometimes sue for payment, the debtor's credit is ruined, and they end up worse off than before they contacted the service."¹¹

Exorbitant Fees

One of the key reasons why consumers will rarely benefit from debt settlement is because they have only a small amount of money, if anything, left over each month after paying necessary expenses. If they had more money, most consumers would be better off repaying their debts through a DMP or some other payment arrangement. If they have no money left over, it is generally best to consider budget counseling from a legitimate counseling agency or possibly bankruptcy.

It is imperative that these consumers get the most out of their limited funds. Instead, the debt settlement companies gouge consumers with high administrative and up-front fees so that their monthly payments to the "reserve" account build up slowly at best. Even in the best case scenario, a consumer with multiple debts will take many years to pay off debts through this process.

The information about fees presented below is based on the data we were able to extract from debt settlement contracts, phone calls to companies, and information from web sites. Unfortunately and quite tellingly, the companies we contacted were reluctant to discuss their fee structures. Most would only say that fees depend on individual situations. Despite these barriers, the data we describe below tells a story of very high fees that are not only unreasonable and unaffordable for many consumers, but also take away valuable resources the consumer could use to actually repay debts.

¹⁰ FTC v. Better Budget Financial Services, Inc., Case No. 04-12326 (D. Mass. Complaint filed November 2, 2004). Ex parte TRO with asset freeze entered November 3, 2003; Stipulation modifying and extending the TRO, November 18, 2004.

¹¹ General comments in giving a D rating to Prosper Financial Solutions (San Clemente, CA), available online at www.labbb.org (accessed February 15, 2005).

Most companies admit to charging a percentage of the amount saved in settlement, plus a monthly fee plus an administrative fee. The percentage of the settlement savings fees range from 10% to upwards of 25%. A few specific examples are presented below.

1. One company charges 15% of the settlement amount ultimately paid by the consumer, plus an up-front fee that starts at \$300/month for the first three months plus administrative fees of \$112/month.

2. A BBB report about one company in our survey found that the company charged an administrative fee plus 25% of settlement savings.¹² The agency also documented numerous complaints from consumers that withdrew from the program, but were not given refunds. According to 2004 documents, this company charged the 25% fee even if the consumer settled the debt on his own, as long as he was enrolled in the program at the time. At this time, the administrative fee was a one time fee of 3% of the total debt amount or \$995, whichever was greater. The company also charged a monthly maintenance fee.

3. A case against a law firm debt settlement company illustrates the serious harm to consumers that arises from companies that charge exorbitant fees and provide little or no services.¹³ The client in this case had \$18,000 in debt from American Express. The agreement authorized the firm to withdraw \$300/month from the client's bank account. For the first four months, the agreement stated that \$284 would be allocated to the monthly office fee, zero would be allocated to the creditor reserve fund (for debt settlement) and \$16 would be charged for a monthly account maintenance fee. For the next 13 months, \$142 would be allocated to the monthly office fee, \$142 to creditor reserve fund and \$16 to monthly maintenance. For the next 19 months, \$284 would go to creditor reserve and \$16 to account maintenance.

The company also charged a 28% reduction of claims fees resulting from the completion of the program. If not completed, the firm still charged \$500/month in administrative costs with a maximum of \$1500 and \$150/hour in litigation costs, with a maximum of \$1500/case. The client dropped out of the program and successfully challenged the law firm's attempt to collect the maximum fee.

4. Another company charges a monthly fee of \$10 for each account with a minimum of \$40 and a maximum of \$70. The company also charges a fee of 25% of actual savings. The twist in this case is that if a settlement is made, the company merely sends the consumer a packet in the mail and instructs the consumer to settle on his own

¹² The San Diego Better Business Bureau, Reliability Report on Debtco Inc. Available on-line at www.sandiego.bbb.org (accessed February 18, 2005).

¹³ See *In re Sinnott*, 845 A. 2d 373 (Vt. 2004).

5. The receiver's report from the National Consumer Council lawsuit includes detailed information about fees.¹⁴ At the outset, the company charged 3.5% of outstanding credit card debt or \$500, whichever was higher. The monthly fee was \$45/month for the first six cards and \$3/card for each additional card. The company also charged \$15 for bounced checks and \$10 check handling fees. If a settlement was made, they charged 25% of money saved. These monthly payments were deducted automatically from the consumer's checking account.

No funds were directed to the consumer's reserve account until the set-up and accumulated monthly fees were paid in full. Ultimately, for a period from 2002 through 2004, only 1.4% of the company's clients completed the program. Of this small group, 29% of the money paid by clients was for fees. For the overwhelmingly majority that did not complete the program, 64% of funds paid were for fees.

6. According to a lawsuit filed by the FTC against Better Budget in November 2004, consumers were promised that the company would negotiate with creditors for a non-refundable retainer fee, monthly administrative fees of \$29.95 to \$39.95 and 25% of any savings.¹⁵

Questionable Value of Services (if any) Performed

It is possible that the fee arrangements described above would be justifiable if the companies actually earned those fees. Unfortunately, it is not easy to determine what the companies actually do to earn these fees. As noted above, the debt settlement trade association (USOBA) and companies we called have either refused to speak with us or provided vague responses.

Our survey of debt settlement companies found that when asked what the companies offer consumers, all stated that their main strength was their relationships with creditors.¹⁶

¹⁴ Robb Evans and Associates, LLC, "Report of Temporary Receiver's Activities, National Consumer Council et al., May 3, 2004-May 14, 2004. First Report to the Court."

¹⁵ FTC v. Better Budget Financial Services, Inc., Case No. 04-12326 (D. Mass. Complaint filed November 2, 2004). Ex parte TRO with asset freeze entered November 3, 2003; Stipulation modifying and extending the TRO, November 18, 2004.

¹⁶ As noted above, few consumers ever complete debt settlement programs. It is critical to explore to what extent this is attributable to creditor refusals to do business with these companies.

These companies also made the following claims about their services. Most commonly they claimed that they had:

- Highly trained negotiators
- Experience in knowing how creditors settle
- No personal emotional attachment to creditors, allowing better responses
- Extensive knowledge in consumer debt and in Fair Credit Reporting Act (FCRA) and Fair Debt Collection Practices Act (FDCPA), even though they are not lawyers, and
- Educational tools

A few companies specifically state that consumers simply cannot get low settlements on their own. Others tout their expertise, claiming for example, that since consumers wouldn't fix their own plumbing, why would they fix their own debt problems?

It is difficult to translate these general claims into actual services offered. All of the companies in our survey claimed to offer some sort of services to stop collection harassment. Some said that they would contact creditors and take over accounts. A law firm debt settlement company said that they attempt to stop creditor harassment, provide legal analysis, but do not represent clients, and make the consumer aware of FDCPA rights. Only one company in our survey claimed to offer a budget review.

The exact nature of these “cease collection harassment” services is unclear. None of the companies in the survey actually provided legal representation for consumers. Of the two law firms, one stated in its enrollment contract that “no legal advice can or will be provided.” The second firm claimed that it would attempt to stop all creditor harassment and provide legal analysis of the consumer's situation.

In some cases, the companies tell consumers that they will request creditors to call the companies instead of the consumers. Although this should not be very time-consuming, this could be a valuable service for some consumers. However, the legal argument is shaky. First, only creditors that meet the definition of “collector” in federal and state fair debt laws are required to stop communicating with consumers. In general, these laws apply only to third party collectors.¹⁷

There is an additional problem even if the creditors are required to comply with the FDCPA. The FDCPA provides that debt collectors cannot communicate with debtors if they know that the debtor is represented by an attorney.¹⁸ The problem is that debt settlement companies repeatedly state that they are not representing the consumers. Thus, the collectors could arguably still contact the consumers unless the consumers send

¹⁷ 15 U.S.C. §1692a.

¹⁸ 15 U.S.C. §1692c(2).

their own cease communication letters. It is a good idea for consumers to do this, but they can usually accomplish this without professional assistance. In fact, many of the companies merely send the consumers a sample letter to fill out on their own. There is ample free advice about how to assert FDCPA rights, including information on government and consumer advocacy group web sites. Certainly some consumers would still benefit from the assistance of a trained lawyer or counselor. Perhaps for a modest fee, this could be a worthwhile service. However, on balance, given the minimal “cease collection” services offered, the fact that consumers continue to face possible collection, including lawsuits, and the exorbitant fees, the costs of debt settlement far outweigh any benefits.

One of the few analyses of the services performed, or not performed, by debt settlement companies can be found in a judicial decision against a law firm debt settlement company.¹⁹ The fees charged by this firm were discussed in the fees section above. The court in this case found that the alleged services performed by the company were routine and automated. Most of these tasks consisted of mailing out form letters to the client and her creditor and responding to client’s occasional phone inquiries as to the status of her case.

The client withdrew from the program and requested an explanation for the costs. The court made no final estimate, but stated that it viewed the estimate of time spent given by the firm of three to four hours as “more than generous.” In finding a violation of the Vermont professional attorney rules, the court found that the work performed was of no value to the client. The firm at no time initiated negotiation with the creditor. Further, the automated or routine tasks actually performed did nothing to advance her goals. Ultimately, the client negotiated a payment plan directly with her creditor without any assistance from the firm.

The statistics from the NCC receiver report show how dubious the claim is that the companies have a “magic formula” to get consumers out of debt. A mere 1.4% of the consumers that entered the program completed it. Forty-three percent cancelled after incurring fees.²⁰

Loss of Consumer Control and Decision Making

All of the companies surveyed require that consumers set up an account and send monthly payments to that account. The companies take their fees from this account each month before crediting anything to the consumer’s reserve. Even a company that stated

¹⁹ See *In re Sinnott*, 845 A. 2d 373 (Vt. 2004).

²⁰ Robb Evans and Associates, LLC, “Report of Temporary Receiver’s Activities, National Consumer Council et al., May 3, 2004-May 14, 2004, First Report to the Court.”

that “the consumer is always in control of his money” admitted that with the consumer’s approval, they deduct their service fee from the account.

Many companies require consumers to give up control of these accounts by requiring them to sign a power of attorney. The FTC lawsuit against National Consumer Council describes how the company required consumers to sign a power of attorney to allow the company to act as attorney in fact. The same allegations were made in cases against Better Budget and Briggs and Baker. There is always potential for abuse when a company requires a consumer to sign a power of attorney and give up control in this way.

False Claims and Representations

Better Business Bureau complaints and lawsuits describe the ways in which consumers are misled about debt settlement company’s claims about their services. In some cases, consumers do not understand that the money is not actually going to the creditors.

In other cases, it is what the companies do not say that causes harm. For example, debtors are rarely told that if their creditors accept a negotiated settlement, the amount forgiven may be reported as taxable income. In any case, none of the companies in our survey offered to provide any tax advice or even information.

A media report describes a typical consumer experience. According to the consumer quoted in the article, “After asking if an adverse credit rating might result, I was assured that I would have no problems with the creditors and that [the company] would assist me in working with the creditors to pay off my debt.” The consumer enrolled, paid \$1040 and then had several accounts go into collection.²¹

In a lawsuit against Jubilee Financial Services, the FTC alleged that the company lured consumers with false promises that they would be able to pay their debts at substantially reduced rates and would stop receiving collection calls. The FTC also alleged that the defendants misled consumers about the effect of debt settlement on their credit ratings.²²

In a case against Briggs and Baker, a California-based debt settlement company, the FTC alleged that the company falsely claimed that it could provide clients with immediate debt elimination and settle credit card debt for pennies on the dollar. In fact, according to the complaint, the company did not have long standing relationships with

²¹ Mike Norris, “Debt Sharks Swim Rising Waters of Consumer Troubles”, *McKinney Messenger* (May 29, 2003).

²² FTC v. Jubilee Financial Services, Inc., et al., Civil No. 02-0648 (C.D. Ca complaint filed August 29, 2003). Stipulation and final order of permanent injunction as to two defendants also filed on August 29. The remaining defendants settled in January 2005.

banks. In addition, the company was usually unable to negotiate any substantial reduction in a consumer's debts.²³

MANY DEBT SETTLEMENT COMPANIES ARE BREAKING EXISTING LAWS

One of the most troubling sides to this industry is that many companies violate state and federal consumer protection laws. Although a number have been sued by government enforcement agencies, enforcement has not been as rigorous as it should be. Nevertheless, even a well-funded enforcement agency cannot pursue every lawbreaker. Self-regulation and compliance is also critical, yet seriously lacking in this industry.

Although many companies appear to violate numerous laws, only the clearest examples are discussed below.

1. Federal and State Credit Repair Laws

The federal Credit Repair Organizations Act (CROA) applies only to agencies that offer credit repair services.²⁴ The definition is broad, encompassing any person who performs or offers to perform any service, for a fee or other valuable consideration, for the express or implied purpose of (i) improving any consumer's credit record, credit history, or credit rating or (ii) providing advice and assistance to any consumer with regard to any activity or service described above.²⁵

The CROA is a powerful law. It requires agencies to make certain disclosures and also includes numerous substantive protections for consumers. For example, the law specifies terms that must be included in contracts with consumers, including a three day right to cancel.²⁶

Violations of the law can lead to extensive consumer remedies. For example, any contract not in compliance with the Act is treated as void.²⁷ In addition, consumers are entitled to actual damages, punitive damages and reasonable attorney fees.

A critical problem with the CROA and its state analogues, particularly in the credit counseling context, is that it generally exempts non-profit organizations.²⁸ However, this is not a concern with for-profit debt settlement companies.

²³ FTC v. Innovative Systems Technology (dba Briggs & Baker), CV 04-0728 (C.D.Ca. complaint filed February 6, 2004).

²⁴ 15 U.S.C. §§ 1679-/1679j. See National Consumer Law Center, Fair Credit Reporting ch. 15 (5th ed. 2002 and Supp.).

²⁵ 15 U.S.C. § 1679a(3)(A).

²⁶ 15 U.S.C. §1679e.

²⁷ 15 U.S.C. §1679f(c).

²⁸ 15 U.S.C. § 1679a(3)(B)(i).

Most debt settlement companies try to elude these laws by claiming that they do not help repair consumer's credit. However, they cannot evade coverage through words if their actions show otherwise. Most of the companies make claims about improving consumer's credit. A number have affiliate companies where they refer consumer to help consumers re-establish credit. A number acknowledge that they give credit repair advice after the consumer is debt free. These are all indications that these companies should be required to comply with the CROA. Credit repair does not have to be their sole or even primary function in order to trigger coverage.

None of the debt settlement agreements we examined included the disclosures required by CROA. The companies simply appear to ignore the law or attempt to evade coverage.

2. Unauthorized Practice of Law

Most states have unauthorized practice of law (UPL) statutes which generally provide for criminal penalties but not for private rights of action in civil cases.²⁹ Violations of these laws may be brought as UDAP actions.

Almost universally, these states limit the practice of law to those who have been licensed and admitted to the state bar association. The definition of the "practice of law" varies by state. Regardless, debt settlement companies arguably cross this line in numerous ways. The fact that these companies feel the need to repeatedly state that they are not giving legal advice demonstrates their concern with possible unauthorized practice of law charges. These claims cannot obscure the reality of their activities.

Many of these companies advise consumers about basic strategies to deal with debt collection and other collection tactics they may face while paying the debt settlement agency and not paying their creditors. The companies claim to help consumers address debt collection harassment by explaining the consumer's legal rights to assert FDCPA and other defenses. They do not actually represent these consumers when trouble arises, but by applying or explaining possible legal claims to an individual's debt situation, they are arguably engaging in the practice of law.

Any company that is not comprised of lawyers or of nonattorneys supervised closely by lawyers is arguably violating the law in this way. Only two of the companies in our survey were law firms. However, even these lawyers claimed that they could not give out legal advice. A few of the companies stated that they had law departments, but again reiterated that they could not offer legal advice and could not represent clients directly. One stated that it could refer consumers to lawyers in their states. Attorneys, as

²⁹ See generally National Consumer Law Center, *Unfair and Deceptive Acts and Practices* §5.12.2.4 (6th ed. 2004).

described in the Vermont case discussed above, may also be subject to state bar disciplinary actions.

3. Unfair and Deceptive Acts and Practices (UDAP) Laws

Every state and the District of Columbia have enacted at least one statute broadly applicable to most consumer transactions. These laws are aimed at preventing consumer deception and abuses in the marketplace.³⁰

Although the laws are different in each state, they generally prohibit unfair, deceptive, and illegal practices. They should apply to both non-profit and for-profit entities.

4. State Debt Management Laws

Nearly every state has a law that regulates or attempts to regulate debt management services.³¹ More than half of these cover debt settlement services as well. Most of these laws appear to cover debt settlement as more of an afterthought (as NCCUSL is doing), but apply nevertheless.

These laws generally apply the same standards to debt settlement companies as they do to debt management agencies. In some states, for-profit debt management or settlement is completely prohibited. In others, substantive provisions such as fee limits and bonding are routinely violated and ignored by debt settlement companies.

Below is a non-exhaustive example of state laws that cover debt settlement companies. A few states that completely prohibit debt management and debt settlement unless performed by attorneys, non-profits or certain other entities are listed first followed by states that allow for-profits to operate, but restrict the fees they can charge and impose other substantive restrictions.

Selected State Laws that Prohibit For-Profit Debt Settlement

Arkansas: Ark. Code Ann. §5-63-301 et seq.

Hawaii: Haw. Rev. Stat. §446-1 et seq.

Kentucky: Ky Rev. Stat. §380.010.,

New Mexico: N.M. Stat. Ann. §56-2-1.

Tennessee: Tenn. Code Ann. §39-14-142.

Wyoming: Wyo Stat. Ann. §33-14-101.

³⁰ See generally National Consumer Law Center, Unfair and Deceptive Acts and Practices (6th ed. 2004).

³¹ See National Consumer Law Center, Unfair and Deceptive Acts and Practices §5.1.2.3 (6th ed. 2004).

Assuming that the law is interpreted to cover debt settlement, debt settlement in these states and states with similar laws should be prohibited.

Selected States That Restrict For-Profit Debt Settlement

California: Cal. Fin. Code §12100 et seq. The law includes debt settlement in the definition. There is a licensing requirement. Certain entities are exempt from licensing, including non-profits, but not for-profit debt settlement companies.

Florida: Fla Stat. Ann. §817.801 et seq. Definition includes debt settlement. Attorneys are exempt, non-profits are not. There are fee limits, e.g. \$50 for initial fee.

Georgia: Ga. Code Ann. §18-5-1 et seq. Exemptions include attorneys, but not for-profit companies. Fee limits.

Idaho: Idaho Code §26-2222 et seq. Licensing requirement. Attorneys are exempt, non-profits are not. Numerous substantive provisions include fee limits of no more than 15% of the amount received by the agency at any one time from or on behalf of the debtor, no other charges allowed.

Kansas: Kan. Stat. Ann. §21-4402, amended by 2004 Kansas Laws ch. 22 (S.B. 509) covers debt settlement. Licensing requirement. Attorneys are exempt. Many substantive provisions, including mandatory education, initial fee of no more than \$50, monthly fee limits of the lesser of \$20/month or \$5/month per creditor.

Minnesota: Minn. Stat. §332.13 et seq. Definition includes debt settlement, licensing provision. Attorneys exempt, certain nonprofits (those operating without charge). Tight fee limits, origination fee of not more than \$25 plus monthly fees limited.

Mississippi: Miss. Code Ann. §81-22-1. Licensing provision. Covers debt settlement. Attorneys exempt. Fee limits and other substantive provisions.

Montana: Mont. Code Ann. §31-3-201. Definition includes debt settlement. Attorneys, certain non-profits exempt. Fee limits and other requirements.

New Jersey: N.J. Stat. Ann. §2C:21-19, 17:16G-1 through 16G-8. Licensing provision. Attorneys exempt. Fee limits.

North Dakota: N.D. Cent. Code §§13-06-01 and 13-07-01 et seq. Attorneys and certain nonprofits exempt. Numerous substantive requirements including bond, fee limits.

Ohio: Ohio Rev. Code Ann. §4710.01. Attorneys exempt. Fee limits and other provisions.

Virginia, Va Code Ann. §6.1-363.2 et seq. Licensing provision. Fee limits of \$75 set up, monthly fee of no more than 15% of total amount discussed, but no more than \$60/month.

Washington:, Wash. Rev. Code §18.28.010 et seq. Debt settlement covered. Attorneys and certain nonprofits exempt. General fee limit requirement and other substantive provisions.

HISTORY OF VERY SERIOUS PROBLEMS

In an area where enforcement is notoriously lax, there have been numerous lawsuits filed by government agencies and private attorneys against debt settlement companies as well as well-documented complaints to the BBB and other agencies. Examples are listed below.

Better Business Bureau Complaints

According to the BBB, “Our experience with debt negotiating companies is that they attract heavily indebted clients by claiming to be able to settle the clients’ debts for far less than the amount owed and to stop creditors’ calls. They often claim, also, that their services are more effective than those provided by credit counseling services.”³² According to a May 2003 article, the number of complaints reported to the BBB nationally about debt settlement tripled from 1057 to 3756.³³ In addition, a 2004 Washington Post article reported that the BBB has received over the past three years about 2,000 complaints about these firms. The most were about National Consumer Council.³⁴

Federal Trade Commission Enforcement

FTC lawsuits include:

1. FTC v. National Consumer Council et al., SACV 04-0474 (C.D. Ca. filed April 23, 2004).

³² See, e.g., Better Business Bureau Company Report on Prosper Financial Solutions, San Clemente, CA. Available at www.labbb.org (accessed on February 15, 2005).

³³ Mike Norris, “Debt Sharks Swim Rising Waters of Consumer Troubles”, *McKinney Messenger* (May 29, 2003).

³⁴ Caroline Mayer, FTC Closes California Credit Counseling Firm, *The Washington Post* (May 5, 2004),

From FTC Press Release (May 5, 2004):

The Federal Trade Commission has filed a complaint against a group of defendants masquerading as a nonprofit debt negotiation organization that has made millions of dollars deceiving consumers into enrolling in their debt negotiation program by promising to reduce their debts. The FTC alleges that National Consumer Council's (NCC) business practices violate the FTC Act, which bars deceptive practices, and have harmed consumers throughout the country. The FTC also charges that the defendants violated the Telemarketing Sales Rule (TSR) by calling consumers who placed their phone numbers on the National Do Not Call Registry. At the FTC's request, a U.S. district court judge has issued a temporary restraining order barring the defendants' illegal activities.

On March 30, 2005, the FTC announced that it entered into separate settlements with the receivership defendants and each of the individual defendants.

2. FTC v. Better Budget Financial Services, Inc., Case No. 04-12326 (D. Mass. Complaint filed November 2, 2004). Ex parte TRO with asset freeze entered November 3, 2003; Stipulation modifying and extending the TRO, November 18, 2004.

From FTC Press Release (November 15, 2004):

An operation billing itself as a debt negotiation company that promised to reduce consumers' debt, negotiate with creditors, and stop harassment from debt collectors in exchange for various fees instead pocketed the fees and plunged consumers deeper into debt, according to the Federal Trade Commission. The FTC charges that Better Budget Financial Services (BBFS) and its principals, John Colon, Jr. and Julie Fabrizio-Colon, have defrauded consumers out of hundreds or thousands of dollars each, causing many to be sued by their creditors and forcing others into bankruptcy. The FTC has asked the court to award consumer redress to the victims of this scam. On November 3, 2004, the court entered a temporary restraining order halting the defendants' illegal business practices, freezing their assets, and appointing a temporary receiver pending a preliminary injunction hearing. The FTC received substantial assistance in bringing this case from Massachusetts Attorney General Tom Reilly's Consumer Protection and Antitrust Division.

On March 30, 2005, the FTC announced that a stipulated final order was filed in this case.

3. FTC v. Jubilee Financial Services, Inc., et al., Civil No. 02-0648 (C.D. Ca complaint filed August 29, 2003). Stipulation and final order of permanent injunction as to two defendants also filed on August 29. The remaining defendants settled in January 2005.

From FTC Press Release (January 26, 2005):

The FTC's original complaint alleged that Jubilee Financial Services, Inc., related company Jabez Financial Group, Inc., and others lured consumers with false promises that consumers who enrolled in their debt negotiation program would be able to pay their debts at a substantially reduced rate and that consumers would stop receiving collection calls from creditors. The complaint also alleged that these defendants misled consumers about the effects of the Jubilee program on their credit report and failed to tell consumers that, as a result of using the defendants' services, negative information would appear on consumers' credit reports and stay there for seven years. The FTC later amended the complaint to add an allegation that the defendants falsely told consumers that money sent to the Jubilee companies would be held in a trust account to be used by defendants to pay off consumers' debts at a reduced rate.

According to the FTC, consumers who enrolled in the defendants' program and paid substantial fees continued to receive phone calls and collection letters from creditors because the defendants did not negotiate substantial debt reductions for consumers. In addition, the FTC alleged that when consumers followed the defendants' directions to cease making payments on their debts, many consumers were sued by the creditors. Consumers allegedly lost money deposited into Jubilee's so-called trust account because the corporate defendants were regularly withdrawing money from the trust account to pay their operating expenses. Instead of finding themselves out of debt, the FTC alleged, many consumers found that their credit was ruined and they were left with little alternative but to file for bankruptcy.

The FTC amended its complaint to add the allegation regarding Jubilee's trust account after determining that more than \$2 million supposedly held in trust for consumers was missing from Jubilee. The amended complaint also added two more related corporations as defendants, Gustavsen Learning Centers, Inc. (GLC), and Debt Relief Counselors of America, P.C. (DRCOA), as well as the two individual defendants who are parties to the settlements announced today. Jemuel Apelar was Jubilee's vice president and the office manager of DRCOA. John Mitchell was DRCOA's titular president.

4. FTC v. Innovative Systems Technology (dba Briggs and Baker), CV 04-0728 (C.D. Ca. complaint filed February 6, 2004). Stipulated final judgment and order for permanent injunction against Jack Briggs filed simultaneously.

From FTC Press Release (February 13, 2004):

The Federal Trade Commission has charged two debt negotiation companies and their principals with violating federal law. Defendants Innovative Systems Technology, Inc. (doing business as Briggs & Baker), Debt Resolution Specialists, Inc., Todd A. Baker, and Jack Briggs (aka John Briggs) claimed they could "drastically" reduce consumers'

debt by negotiating directly with creditors. The FTC charges that the defendants' radio advertisements and Internet Web sites were false and misleading and that the defendants were unable to negotiate substantial reductions in the amount consumers owed. The FTC further alleges that, as the result of purchasing defendants' debt negotiation services, consumers' credit ratings suffered, their total debt increased, and that some consumers even became the target of legal action.

The FTC's complaint against the California-based defendants states that, under the direction of Todd Baker and Jack Briggs, Briggs & Baker advertised debt negotiation services to consumers since at least 1999. Briggs & Baker's radio and Internet ads allegedly claimed that the company could negotiate with consumers' creditors, which would enable consumers to pay off their debts for a fraction of the amount originally owed. The FTC alleges that, after consumers signed up for the service, Briggs & Baker directed them to stop making payments to all of their unsecured creditors and that Briggs & Baker would prevent further contact from their creditors. Briggs & Baker purported that its services were risk-free and guaranteed.

The FTC's complaint states that many of Briggs & Baker's claims were false, that Briggs & Baker usually was unable to negotiate any substantial reductions, and that consumers' failure to make payments or respond to creditors' payment demands – as per Briggs & Baker's instructions – typically resulted in increased debt, additional charges, and damage to consumers' credit reports. The FTC charges that, in some cases, Briggs & Baker did not even contact consumers' creditors to negotiate a settlement. Thus, after months of being told that Briggs & Baker was settling their accounts, many consumers found that creditors had sent their accounts to a collection agency or even initiated legal actions against them. The FTC further alleges that Briggs & Baker failed to honor its refund policy.

RECOMMENDATIONS AND CONCLUSIONS

1. Debt settlement practices should be separately regulated from debt management practices. The fact that both businesses target the same consumers is not a reason to regulate them with a broad brush. There are other abusive practices, such as debt elimination or debt termination, which NCCUSL and the states have yet to address even though these businesses also target and in many cases harm consumer debtors.
2. Debt management, when performed by a legitimate counseling agency and when performed in combination with holistic counseling and educational services, can benefit some consumers. However, the debt settlement business model that requires consumers to stop paying creditors, save money in reserve accounts, and pay large fees does not benefit consumers. Any new law that regulates debt settlement should prohibit this business model. Debt settlement assistance should be allowed only when consumers have already saved money or otherwise have the money to attempt to settle a debt and are seeking assistance with negotiation. To the extent these services are considered the practice of law, they should be performed only by attorneys or counselors or other advocates working under attorney supervision.
3. Existing laws, if properly enforced, could go a long way toward challenging abusive debt settlement companies. Common law fraud and breach of contract should also be considered. It is not necessary in all cases to craft a new law since credit repair, some state debt settlement, unfair and deceptive practices laws and possibly other consumer protection laws are also available. However, existing laws will generally be more effective if enforced in combination with a more targeted debt settlement law (see #2 above).