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MEMORANDUM

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To: Consumer Debt Counseling Drafting Committee
From: Michael Greenfield, Reporter
Subject: Initial Report

A. Introduction

Consumer credit counseling agencies assist consumers who have problems managing their debts. They do so by providing some or all of the following services:

- counseling the consumer about managing his or her household finances and budgeting expenses to match income; this counseling may occur face to face in individual or group sessions, or it may occur on the telephone or on the Internet;
- creating a debt management plan (DMP) plan for the payment of the consumer's credit card debt;
- acting as an intermediary between the consumer and some of his or her unsecured creditors, for the purpose of reducing interest rates and delinquency fees; and
- acting as a disbursement agent, receiving monthly payments from the consumer and remitting them in appropriate amounts to each of the participating creditors.

Counseling agencies are compensated for these services primarily in two ways. The creditor that receives payments pursuant to a DMP may make a payment to the counseling agency based on the amount of funds it has received. And the consumer who receives individual services may pay for them. In addition, though less likely, counseling agencies may receive money from such funding entities as United Way.

B. History

The consumer credit counseling industry originated in the early twentieth century in the form of debt adjusters (also known as debt poolers, debt consolidators, debt managers, or debt pro-raters). This first generation of credit counselors consisted of profit-seeking enterprises that communicated with a consumer's creditors seeking to persuade them to accept less than full payment in satisfaction of the consumer's obligations. If the creditors agreed, the debt adjuster would collect a monthly payment from the consumer and forward appropriate portions of it to each of the creditors. They often charged hefty fees, leaving little for distribution to the creditors. The instances of deceptive advertising and defalcation of clients' funds were numerous enough that, starting in the 1950s, legislatures in more than half the states outlawed the business. E.g., N.Y. Gen. Bus. Law §§ 455-457. Of the remaining states, approximately two thirds opted for a regulatory approach, requiring licenses, imposing requirements on how the businesses operate, and restricting troublesome practices. E.g., Mich. Comp. Laws Ann. Ch. 451, §§ 451.451-.465 (repealed in 1976 and replaced by §§ 451.411-.437).

Many states excluded not-for-profit organizations from the scope of these statutes, enabling non-profits to render counseling services free of regulation. This led to the growth, starting in the 1950s, of non-profit counseling agencies, the second generation of credit counselors. The growth of these non-profits was fueled by the National Foundation for Consumer Credit (now renamed the National Foundation for Credit Counseling), which was created by retailers and banks that issued credit cards. These creditors supported the formation of non-profit credit counseling agencies as a means of helping consumers in financial difficulty get back on track and pay their credit card debts. The objectives were full repayment of debt and the avoidance of bankruptcy.

The counseling agencies provided community education, met individually with consumers, helped them develop or improve budgeting skills, and, when appropriate, enrolled them in a "debt management plan" (DMP). To establish a DMP, the agency negotiated with each of the consumer's unsecured creditors to obtain concessions from them, in the form of some combination of reduced interest rate, waiver of default or delinquency fees, and monthly payments in an amount less than the contractual minimum. Thereafter, the consumer made monthly payments to the agency and the agency disbursed a pro-rated amount to each of the participating creditors. The creditors supported the counseling agencies by returning to them a percentage—often 15%—of the payments they received. The NFCC called this contribution the creditor's "fair share." The agencies also sometimes received charitable contributions from other sources and imposed modest fees on the consumer. This second generation of counseling agencies still operates.

Consumer advocates generally acknowledged the educational and budgeting benefits that the counseling agencies provided, but were critical—or at least skeptical—of their overall usefulness. They perceived the agencies as collection agents for the credit card industry and were critical of the limited range of advice the agencies provided. The last thing a card issuer wanted to see was a consumer filing a petition in bankruptcy. Formed and supported primarily by the credit card industry, most counseling agencies never recommended bankruptcy, and many never even mentioned it as a possibility.

The late 1980s and 1990s saw a dramatic increase in credit card debt. Consumers' income rose, and card issuers relaxed their standards of creditworthiness. The increase in debt was accompanied by an increased opportunity for credit counseling agencies. Many new entities arose, unaffiliated with the NFCC. They formed competing trade associations e.g., the Association of Independent Consumer Credit Counseling Agencies (AICCCA) and the American Association of Debt Management Organizations (AADMO)). These new agencies—the third generation—relied heavily on advertising and telemarketing, and many conducted their business with consumers entirely by telephone or over the Internet. Perhaps because of their aggressive marketing and innovative business methods, their share of the counseling market grew from approximately 20% in 1996 to approximately 80% in 2001. Their focus was on the creation of DMP's, not on budgeting and education, which often fell entirely by the wayside.

Since many states prohibited for-profit debt management businesses, members of this third generation of agencies were organized as non-profit entities. Many of them, however, did not operate as charitable or educational institutions. They uncritically enrolled all their customers in a DMP, even if it were not suitable for them, and they charged fees much higher than the fees charged by the agencies affiliated with the NFCC. At the traditional level of the creditors' fair share contribution, and with the educational function stripped away, many agencies generated revenues much larger than needed to provide debt management services. They funneled off these excess revenues in such ways as salaries that were out of line with the salaries paid by other kinds of non-profit entities in the community, and as compensation to affiliated entities for back-office services.

Meanwhile, credit card issuers discerned that some of the counseling agencies were accumulating large surpluses and were enrolling in DMP's consumers whom the issuers believed could pay their debts without the concessions the issuers had been giving. They responded by reducing the concessions they were willing to make and by reducing the amounts they were willing to return to the counseling agencies. Some creditors have stopped supporting the agencies altogether, and on average the amount returned to the agencies has dropped from more than 12% to less than 8%. This decrease has adversely affected the ability of counseling agencies to provide individual counseling and community education.

The objective of the counseling agencies discussed to this point is to enable consumers to repay their debts in full. There is, however, another segment of the industry—the fourth generation—whose members do not have this objective at all. These entities are sometimes known as debt settlement companies, and they have formed trade associations of their own (e.g., the National Association of Consumer Debt Settlement Companies (NACDSC) and the National Debt Settlement Association (NDSA)(formerly the National Foundation for Debt Settlement)). Instead of helping the consumer pay his or her creditors in full, they attempt to persuade creditors to settle for less than the full amount of the consumer's debt, writing off the rest. Thus they represent a revival of the first generation of counseling agencies. Unlike their forebears, however, they do not negotiate with the creditors in advance of a consumer's default. Instead, they encourage the consumer to default. The consumer makes monthly payments to the agency, not to the creditors. The agency accumulates those payments until they reach a target percentage of the consumer's debt to his or her creditors. Then the agency submits an offer to the creditors (on the consumer's behalf) to settle the debt for the amount in hand. During the period when the agency is accumulating payments from the consumer, the creditors receive nothing. As a result the creditors impose additional finance charges and delinquency fees and may undertake collection activity.

C. The Bankruptcy Code and Other Legislation Mandating Consumer Credit Counseling

A pending amendment to the Bankruptcy Code (Bankruptcy Abuse Prevention and Consumer Protection Act, H.R. § 106(a)) imposes two requirements relevant to this project. First, as a condition to filing for relief, a debtor must present a certificate from an approved counseling agency that he or she has been informed of alternatives to bankruptcy. Second, as a condition to a discharge, the debtor must have completed a course of study on personal financial management. These counseling functions must be obtained from agencies certified by the U.S. Trustee as meeting certain standards. This amendment has the potential to double the number of consumers who seek credit counseling.

In addition to this proposed federal requirement, several states already have enacted legislation requiring or encouraging certain consumers to obtain credit counseling. New York imposes this requirement in connection with high-cost mortgage loans. Florida and Illinois do so in connection with certain payday loans.

D. Existing Regulation

In 1996 Congress enacted the Credit Repair Organizations Act, 15 U.S.C. §§ 1679-1679j. The focus of that legislation is entities that purport to be able to improve the consumer's credit reports or credit rating. It would apply to many consumer credit counseling agencies, but the definition of "credit repair organization" excludes non-profit organizations that are exempt from federal taxation. Though this legislation is not applicable to credit counselors, the committee may wish to draw on many of the restrictions it imposes on credit repair organizations.

As noted above, more than half the states ban consumer credit counseling (with a loophole for entities that provide counseling services on a non-profit basis). Of the rest, most have statutes regulating the business. These statutes take a variety of approaches; some create an elaborate licensing structure, others mandate or prohibit specified practices. These approaches and these statutes provide another resource on which the committee may draw in fashioning a uniform act.

E. Issues To Be Addressed

Assuming that the drafting committee does not recommend outlawing credit counseling altogether, there are numerous facets of the business that might be addressed. They include:

1. *Lack of adequate training for individual counselors*. Some agencies are affiliated with trade associations (NFCC, AICCCA) that require the agencies to use counselors who have been certified as having been trained to provide financial management counseling services. Employees at other agencies typically have received no training as counselors.

2. *Diminution or elimination of the counseling function*. The reduction in amounts that creditors pay counseling agencies has led to a reduction of the counseling and public education functions at many agencies. Often there is no face-to-face interaction between counselor and consumer. Sometimes the counseling and educational functions occur by telephone

or on-line, but many of the third-generation agencies have no counseling or public education functions. Enactment of the proposed bankruptcy amendment would necessitate that agencies incorporate counseling activity, at least for those consumers who are contemplating filing for bankruptcy. The effectiveness of long-term oversight by the U.S. Trustee is an unknown.

3. *Use of deception to initiate communication with the consumer*. Print and web site ads, television ads, and telemarketing callers may promise more (e.g., credit repair) than the counseling agencies can deliver. They may misrepresent that the agency will provide counseling services even though the agency's sole service is operation of a debt management plan.

4. *Use of deception and high pressure tactics to induce consumers to enroll in a DMP*. Many consumers who consult counseling agencies only need assistance with budgeting and general financial management skills. They do not need a DMP. But agency employees, especially those who are not trained as counselors, may be paid according to the number of consumers they enroll in DMP's. The agency itself derives income from the creditor only if the consumer enrolls in a DMP. With reduced payments from creditors, an increased portion of the agency's income now comes from the set-up fee paid by consumers. These incentives are conducive to deception and high pressure. For example, some agencies induce consumers to enter a DMP by suggesting that they may earn referral fees by referring other consumers to the agency.

5. *Use of deception in connection with fees*. Some agencies misrepresent or fail to disclose accurate information concerning the amount the consumer must pay for the agency's services. Many counseling agencies tell consumers that there is no charge for their services. Instead, they tell consumers that they will be asked for voluntary contributions. At some agencies, this representation is false, and the fees are mandatory. At others, the pressure to make the so-called voluntary contribution is so intense that it is in effect a fee for services rendered. Some agencies fail to disclose in advance that there will be fees in addition to the ones that are disclosed.

6. *Failure to disclose the percentage of the agency's consumers who successfully complete a DMP*. Typically fewer than a third of the consumers who enroll in a DMP see it through to the end. Failure of a plan means that the consumer still owes the debts to his or her creditors, but has diverted to payment of the agency's fees money that otherwise could have reduced those debts. The consumer should have the information helpful to making the decision to undertake a DMP. A requirement of disclosure of the success rate may provide agencies with

an incentive to enroll in a DMP only those consumers the agency believes will complete it.

7. *Failure to disclose the fact and amount of compensation received from creditors*. Consumers may believe that the counseling agency is acting on behalf of the consumer, when in fact the agency is beholden to his or her creditors. With the Federal Trade Commission's blessing in 1997, the NFCC began requiring its member agencies to disclose this dual loyalty to its consumer customers. Indeed, since a counseling agency is an agent of the consumer, counseling agencies that fail to make this disclosure may be subject to liability for breaching obligations imposed by the law of agency.

8. *Failure to inform the consumer of all the options*. Just as a DMP may not be appropriate because the consumer needs less, so also a DMP may not be appropriate because the consumer needs more. Many agencies do not treat bankruptcy as an alternative, and most do not include bankruptcy among the recommended solutions for a consumer's problems. This derives from the agencies' connections to the creditor community and reflects the fact that if the consumer is not in a DMP the agency receives no payment from the creditors.

9. *Failure to inform the consumer of the significance of secured debt*. Secured creditors, e.g., mortgagees and auto lenders, do not cooperate with counseling agencies. The consumer must continue to pay them outside the plan. Some agencies may fail to make this clear to the consumer.

10. *Failure to disclose the impact of a DMP or a debt settlement program on the consumer's credit report*. The consumer may not be aware of the impact of each of these on his or her credit report. The consumer may be misled into believing that bankruptcy would have a greater negative impact than a DMP would have.

11. *Refusal by the agency to deal with creditors that do not financially support it*. Some unsecured creditors, including some credit card issuers, refuse to make any payment to counseling agencies. If the agency refuses to include these creditors in a DMP, the consumer is left to deal with them outside the plan.

12. *Absence of a written contract detailing the obligations of each party under a DMP*.

13. *Receipt of funds from the consumer before the creditors have agreed to participate in a DMP*. If the agency advises the consumer to start paying

the agency before it has secured the creditors' assent to the plan, the consumer will be in default, triggering delinquency fees and perhaps collection activity.

14. *Imposition of high fees for the services rendered*. Historically, the NFCC-affiliated agencies charged consumers nothing or a nominal amount for operating a DMP. With the decline in the amounts that creditors pay the agencies, they have increased their fees to consumers. In 2001 the average for NFCC agencies was $19 for creating a DMP and $12 per month for administering it.

The third-generation agencies tend to charge much higher fees than the second-generation NFCC agencies. A typical set-up fee is $50, though at some it is an amount equal to the aggregate monthly payment that in subsequent months will be distributed to creditors. The monthly fee for these agencies varies; at some, the fee is $5-10 per account; at others, it is a percentage of the total monthly payment; at still others, it is a flat fee.

The fourth-generation (i.e. debt-settlement) companies impose even higher fees. Their set-up fee may be as high as the aggregate monthly payment, and they often charge a percentage (typically 25%) of the amount of debt that the creditors write off.

Some existing state statutes place a cap on fees. At the low end, the cap may be $39 plus the lesser of $50 or 1% of the debts covered by a DMP. At the high end, the cap is 15% of each monthly payment.

To the extent counseling agencies market their non-profit status, they may be playing on a perception of consumers that the mission of non-profit entities is charitable or educational, with fees set at the level necessary just to cover expenses. There is an element of deception, therefore, when the fees produce excessive reserves or when they are funneled to for-profit companies that are affiliated with agency insiders, or when the expenses are inflated by overly generous salaries to agency executives. The committee might address this deception, as well as the propriety of price controls and the appropriate level of any such control.

15. *Failure to disburse funds to creditors*. The consumer who is enrolled in a DMP makes a single monthly payment to the counseling agency. The agency in turn is supposed to send payment to each of the participating creditors. There are instances in which agencies have failed to make those payments. There are instances in which agencies have refused to make payments to creditors that did not agree to a DMP, but failed to inform the consumer that payment was not being made. There are more numerous instances in which agencies have failed to make payments

promptly. Problems also may arise because the due dates of the payments to creditors are not coordinated properly with the date on which the agency receives payment from the consumer.

16. *Failure to respond to inquiries of consumers who are enrolled in a DMP*. Articles in the popular press report instances of consumers' inability to communicate with agencies once a DMP is under way.

17. *Misappropriation of money paid by consumers in a DMP*. There are instances in which the counseling agency absconded with funds.

18. *Misappropriation of financial information*. The consumer must disclose detailed financial information to the counseling agency. The agency may give or sell this information to third parties that hope to do business with the consumer.

19. *Abuse of tax-exempt, non-profit status*. Non-profit status is a function of state law and typically requires that the corporation be organized for a public or charitable purpose (Or. Rev. Stat. §65.047(b)) or for "any lawful purpose not involving pecuniary profit or gain for its directors, officers, shareholders, or members" (Mich. Comp. Laws §450.2251). Tax-exempt status is a function of the federal Internal Revenue Code and requires, among other things, that the entity not be operated for the private inurement of any person. Some agencies pay lavish salaries to directors or executives. Some agencies have relationships with companies owned by agency insiders and channel large sums to those companies in the form of above-market lease payments or contracts for ancillary services, such as operation of the DMP's. Some agencies refer consumers to insider-owned companies for consolidation loans or other services.

The IRS recently announced that it was auditing a number of existing counseling agencies and would be increasing the rigor of its reviews of new applicants for tax-exempt status. (N.Y. Times, Oct. 14, 2003). (Additional information is available at the IRS web site (search for "credit counseling.")) The committee may wish to consider limitations on the governing structure of counseling agencies and the appropriateness of restrictions on an agency's engaging in transactions with insiders.

20. *Solicitation of consumers who reside in a state distant from the counseling agency*. The interstate nature of operations adds to the difficulty of supervising the agency and enforcing the law against it.

21. *Practice of law without a license*. Counseling agencies examine a consumer's financial situation and may recommend that the consumer do or do not file for bankruptcy. Debt settlement companies may advise

the consumer what to do if he or she is dunned or sued, and they routinely represent that they have the expertise to know when to make a settlement offer to the consumer's creditors. These activities may amount to the unauthorized practice of law. (Home Budget Serv., Inc. v. Boston & Massachusetts Bar Ass'ns, 335 Mass. 228, 139 N.E.2d 387 (1957))

In addition to considering each of these aspects of the industry's operations, it will be necessary to determine:

- what entities, if any, should be exempt from the regulation
- the nature of any administrative structure, e.g., licensing, rulemaking
- bonds, audits, examinations
- remedies, public and private

F. Bibliography

Among the numerous publications on credit counseling, several stand out. If you wish to pursue the literature, I recommend you start with some or all of the following, in the following order:

Loonin & Plunkett, Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants (Report by Consumer Federation of America and the National Consumer Law Center, April 2003) (accompanies this report)

Losing Credibility: Troubling Trends in the Consumer Credit Counseling Industry in Massachusetts (Report of the Senate Committee on Post Audit and Oversight, April 2002)

Williams, Consumer Credit Counseling Services: A Growing Private-Sector Response to Counterproductive Collection Practices that May Lead to Bankruptcy, 7 J. Bankr. L. & Prac. 47 (1997)

Hoffman, Consumer Bankruptcy Filers and Pre-Petition Consumer Credit Counseling: Is Congress Trying to Place the Fox in Charge of the Henhouse? 54 Bus. Law. 1629 (1999)

Millstein & Ratner, Consumer Credit Counseling Service: A Consumer-Oriented View, 56 N.Y.U. L. Rev. 978 (1981)

Felsenfeld, Consumer Credit Counseling, 26 Bus. Law. 925 (1971)