**M E M O R A N D U M**

June 14, 2004

To: NCCUSL Committee of the Whole
From: Drafting Committee for the Consumer Debt Counseling Act
William C. Hillman, Chair
Michael M. Greenfield, Reporter
Subject: Two Issues on which the Committee Seeks Guidance

The Consumer Debt Counseling Act is before the Conference for its first reading this summer. In addition to the usual guidance the Conference provides at this stage, the Drafting Committee solicits the view of the Committee of the Whole on two particular issues. One concerns the scope of the Act, and the other concerns a substantive requirement for counseling agencies.

Background

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.[1] 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.[2]

Many states exempted not-for-profit organizations from these statutes, enabling non-profits to render counseling services free of regulation. This led to the growth, starting in the 1950s, of the second generation of credit counselors. The growth of these non-profits was fueled by the National Foundation for Consumer Credit (NFCC) (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 credit counseling agencies as a means of helping consumers in financial difficulty gain control of their finances and pay their credit card debts. The objectives were full repayment of debt and the avoidance of bankruptcy.

[1] E.g., N.Y. Gen. Bus. Law §§ 455-457.

[2] E.g., Mich. Comp. Laws Ann. §§ 451.451-.465 (repealed in 1976 and replaced by §§ 451.411-.437).

The counseling agencies provided community education, met individually with consumers, helped them develop or improve budgeting skills, and, when appropriate, enrolled them in debt-management plans (DMP's). 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 the amount of debt was accompanied by an increase in the amount of debt in default and 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—rely heavily on advertising and telemarketing, and many conduct 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. For the most part, their focus is on the creation of DMP's, not on budgeting and education, which at many agencies has fallen entirely by the wayside.

Since many states prohibit for-profit debt-management businesses, and since card issuers limit their fair-share payments to non-profit agencies, members of this third generation of agencies are organized as non-profit entities. Many of them, however, do not operate as charitable or educational institutions. They uncritically enroll all their customers in DMP's, and they charge 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 generate revenues much larger than needed to provide debt-management services. They disburse these excess revenues in the form of generous compensation to affiliated entities that provide back-office services. They also pay salaries for the principal executives that are out of line with the salaries paid by other kinds of non-profit entities in the community.[3]

Meanwhile, in the 1990s credit card issuers saw that their fair-share payments to counseling agencies had increased to the extent that those payments approximated the amounts they were paying for all their other collection activities combined. In addition, they discerned that some of the counseling agencies were accumulating large surpluses and were enrolling in DMP's consumers whom the creditors believed could pay their debts without the concessions the creditors had been giving. They responded by reducing the concessions they were willing to make to consumers and by reducing the amounts they were willing to pay the counseling agencies. Some card issuers 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. Some major card issuers have abandoned the fair-share approach altogether and are developing proprietary models for compensating counseling agencies depending on such factors as the profiles of the debtors being served by an agency, the agency's record with the creditor, and the agency's advertising and business practices.

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 and the National Debt Settlement Association (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 on the debts and to make monthly payments to the agency or to a savings account. When those payments reach a target percentage of the consumer's debt to one of his or her creditors, the agency submits an offer to that creditor (on the consumer's behalf) to settle the debt for the amount in hand. During the period when the funds are accumulating, the creditors receive nothing. As a result the creditors impose additional finance charges and delinquency fees, and they may undertake collection activity, including litigation.

## Scope

When it first authorized this project, the Executive Committee focused on the

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[3] For a description of three different models for channeling funds to related entities, see Staff Report, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling (Permanent Subcommittee on Investigations of the Senate Governmental Affairs Committee) (March 2004), available at http://govt-aff.senate.gov/_files/032404psistaffreport_creditcounsel.pdf.

segment of the industry that counsels consumers and forms debt-management plans to assist them pay their debts in full. It did not contemplate those entities engaged in debt settlement. In a July 9, 2003, memorandum to the Committee on Scope and Program, the Chair and the Reporter of the Drafting Committee recommended that “[t]he drafting committee’s charter should permit the committee to determine whether regulation of the consumer credit counseling industry should encompass firms engaged in ... debt settlement activity.” The Committee on Scope and Program concurred.

The Drafting Committee has tentatively decided that the Act should encompass debt settlement agencies. Although debt settlement agencies help consumers satisfy their indebtedness on terms of less-than-full payment, whereas credit counseling agencies help consumers pay their debts in full, both types of agencies are engaged in helping consumers satisfy their obligations to their creditors. Some issues are unique to each kind of agency, but many issues are common to both. For example, both kinds of agency have used deception to induce consumers to form agreements. Both have deceived consumers about the cost of their services. Both have charged fees that many observers believe are far in excess of the value of the services provided. Both have fiduciary obligations to consumers who entrust them with funds to be paid to the consumers’ creditors. Legislation recently enacted in some states apples to both. The Drafting Committee believes that the Act should encompass debt-settlement agencies and requests the Committee of the Whole to endorse the decision to include them within the scope of the Act.

Non-profit status

As stated above, starting in the 1950s, most states banned the business of debt-adjusting. Of the states that permitted the business, most regulated it. Many of the states adopting either of these approaches provided an exemption for non-profit entities, and credit counseling agencies have arisen by virtue of this exemption. The agencies have obtained tax-exempt status from the Internal Revenue Service, but many of them evade the requirements for that status and operate for the financial benefit of the agency’s insiders. The IRS has announced that it is reviewing the tax-exempt status of several agencies and is heightening its examination of applications by newly formed credit counseling agencies.[4]

The question before us now is whether the Consumer Debt Counseling Act should require credit counseling agencies to be not-for-profit entities. Historically, most states have imposed this requirement. In recent years several states have enacted or substantially revised their statutes governing credit counseling agencies. Some of these recent enactments permit agencies to operate on a for-profit basis, but most limit the

[4] Non-profit status is a matter of state law. Tax-exempt status is a matter of federal law. In some states the statute governing credit counseling uses the term “non-profit” or “not-for-profit.” In others, it uses a term like “exempt under section 501(c)(3) of the Internal Revenue Code.” As used in this memorandum, the terms are interchangeable.

activity to non-profits.[5]

Several arguments favor each position. Perhaps the strongest argument for abandoning the requirement of non-profit status is that the profit motive stimulates innovation and efficiency. As an incentive to improve business operations, nothing beats the lure of financial gain. Competition will drive agencies to provide the product that best meets the needs of consumers, and at the lowest cost. Hence, almost all segments of the financial services industry-- even those that serve poor or stressed consumers-- are profit-seeking enterprises. (Exceptions include credit unions and community development organizations.)

If the business is limited to non-profits, some agencies will seek to evade the restrictions posed by the IRS' ban on private inurement. This creates a need for legislation to attempt to anticipate those evasions and regulate them. If for-profit entities are permitted to operate, this regulation becomes unnecessary. Any concern about excessive profits can be addressed by focusing on the prices that counseling agencies charge for their services. By regulating the maximum fees agencies may charge, the Act can eliminate the possibility of excessive profits.

On the other hand, there are arguments for continuing the requirement that agencies be not-for-profit. If fee-setting is appropriate, then setting fees at levels appropriate for distressed debtors will leave little, if any, room for profit. To the extent this is the case, there is little reason to permit for-profits in the first place. Some proponents of permitting for-profits have argued that the Act should not set caps on fees because a competitive market will produce appropriate prices. If the Act permits for-profits and does not set fee caps, however, the worst of the existing abuses will continue.

The model of the free market and the power of competition to produce the best goods or services at the lowest price is quite powerful. Unfortunately, the reality does not always match the model. This is often the case with respect to the markets serving low- and middle-income consumers. Payday loans may be a good current example: there are numerous providers, each operating very profitably, and yet prices remain quite high. Like customers of payday lenders, consumers who use the services of credit counseling agencies typically are facing a financial emergency. They often are emotionally distraught and vulnerable. It is debatable whether they are better served by an entity seeking to profit from the service it provides or an entity seeking to help them get out of a difficult situation and prevent its recurrence.

One of the historic functions of counseling agencies is education concerning personal finances. At the agencies that take this function most seriously, only a third of the consumers they counsel enter a debt management plan. For a credit counseling

[5] For example, the Georgia and Kansas statutes permit for-profits, but the recent legislation in Maine, Maryland, Mississippi, New York, and Virginia does not. Ga. Code. Ann. § 18-5-2; 2004 Kans. Advance Leg. Serv. 22; 17 Me. Rev. Stat. § 701 and Me. Rev. Stat. tit. 32, § 6173(1); Md. Code Ann., Fin. Inst. § 12-908(b)(11); Miss. Code Ann. § 81-22-5(1); N.Y. Gen. Bus. Law §§ 455(4), 456 and N.Y. Banking Law § 579; Va. Code Ann. § 6.1-363.4(B)(5).

agency to obtain tax-exempt status, it must be organized and operated exclusively for charitable or educational purposes. An agency not seeking that status need not be concerned with providing education. But the Drafting Committee believes that an essential component of credit counseling services is education in the management of personal finances. Hence, the current draft of the Act imposes an obligation on counseling agencies to provide education and counseling. But it is very difficult to formulate standards for that activity and to enforce those standards. If agencies may be for-profit entities, they are likely to be tempted to cut corners when it comes to education and counseling. By requiring tax-exempt status, the Act would emphasize the educational function of credit counseling. It would eliminate the profit-making motivation, with its incentives to cut corners and take advantage of consumers. And it would enhance the likelihood that consumers will receive the services that will enable them to avoid a recurrence of the problems that brought them to a credit counselor.

The Drafting Committee requests the Committee of the Whole to provide it with guidance on the question whether the Consumer Debt Counseling Act should require credit counseling agencies to be organized as non-profit, tax-exempt entities.