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Protecting Consumers from Consumer Credit Counseling

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I. INTRODUCTION

With $30,000 in credit card debt, Jolanta Troy's divorce left her unable to pay her bills, but she became more hopeful after seeing a television commercial for the non-profit company AmeriDebt.[1] Concerned she would lose her home, Ms. Troy contacted AmeriDebt where a counselor suggested she enter a debt management plan (DMP).[2] Under a DMP, Ms. Troy would send one reduced monthly payment directly to AmeriDebt, and AmeriDebt would in turn pay her creditors.[3] Ms. Troy wanted to weigh her options, but after she hung up the AmeriDebt counselor called her back four times.[4] The counselor reminded Ms. Troy that AmeriDebt was a non-profit organization and warned her she needed AmeriDebt's help.[5] Eventually, Ms. Troy relented and agreed to a DMP with AmeriDebt.[6] Although she remitted her first payment of $783.00 to AmeriDebt, Ms. Troy began to receive calls from her creditors demanding payment.[7] Ms. Troy contacted AmeriDebt and learned that her initial payment was considered a "contribution" to AmeriDebt.[8] Missing payments to creditors only worsened Ms. Troy's fiscal condition and forced her to file for bankruptcy.[9]

Jolanta Troy's story is not uncommon amongst debtors who go

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1. *Profiteering in a Non-profit Industry: Abusive Practices in Credit Counseling Before S. Subcomm. on Investigations*, 108th Cong. 16 (2004) [hereinafter *Senate Hearing*] (statement of Jolanta Troy, Customer, AmeriDebt).

2. *Id.*

3. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 6 (Apr. 2003), *at* http://www.consumerfed.org/credit_counseling_report.pdf.

4. *Senate Hearing*, *supra* note 1, at 16 (statement of Jolanta Troy, Customer, AmeriDebt).

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.* at 17.

9. *Id.*

to Credit Counseling Agencies (CCAs) for help.[10] Advocacy groups including the Consumer Federation of America and the National Consumer Law Center have documented these practices among a select group of Recent Entrants to the credit counseling industry.[11] These Recent Entrants systematically deceive their customers and prey on individuals who are already too indebted to pay their bills.[12]

Part II of this note provides a brief overview of the origins and early practices of CCAs.[13] Part III describes the practices of Recent Entrants to the credit counseling industry.[14] Part IV discusses current state and federal law regulating CCAs and the weaknesses of these methods of enforcement.[15] Finally, Part V argues that stricter IRS enforcement of non-profit status is the best method of regulating CCAs.[16]

II. EARLY CREDIT COUNSELING DEVELOPMENT AND PRACTICES

Understanding the complaints of consumer advocates against these controversial institutions requires a short analysis of the development of consumer credit counseling. Credit counseling first emerged in the 1950's, when credit institutions helped to establish local CCAs to limit bankruptcy filings and avoid potential losses.[17]

Traditionally, CCAs provided one-on-one counseling[18] aimed at

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10. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 31-32.

11. *See* MAJORITY & MINORITY STAFFS OF THE PERMANENT SUBCOMM. ON INVESTIGATIONS, 108TH CONG., PROFITEERING IN A NON-PROFIT INDUSTRY: ABUSIVE PRACTICES IN CREDIT COUNSELING 6-7 (2004) [hereinafter MAJORITY & MINORITY]. Senate scrutiny focused upon complaints against Cambridge Credit Counseling, AmeriDebt, and Amerix although this is by no means an exhaustive list. *Id.* Because the credit counseling industry contains beneficial and harmful institutions, offending institutions are called Recent Entrants throughout this Note. The term recent is not chosen to imply that all new credit counseling agencies are unscrupulous, but rather recognizes that the more harmful practices to consumer do tend to come from new CCAs. CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3.

12. *See* Jeff Gelles, *Debt Counseling Can be Anything But; A Probe Finds these Nonprofits can be Fronts for Operations Preying on Those in Financial Distress*, PHILADELPHIA INQUIRER, Apr. 25, 2004, at E04.

13. *See infra* notes 17-35 and accompanying text.

14. *See infra* notes 36-78 and accompanying text.

15. *See infra* notes 79-119 and accompanying text.

16. *See infra* notes 120-51 and accompanying text.

17. *See* MAJORITY & MINORITY, *supra* note 11, at 25.

18. *Id.* at 2-3.

teaching the debtor how to effectively budget.[19] Counseling was an effective way to ensure that debtors would alleviate current debt and avoid excessive indebtedness in the future.[20] When appropriate to the debtor's financial condition, traditional CCAs also offered a DMP.[21] A DMP is essentially an agreement by the creditor to give concessions to the debtor.[22] The CCA facilitates this agreement by negotiating creditor concessions.[23] Traditional CCAs facilitated the process because of their familiarity with the concession policies of various creditors.[24] The concessions commonly obtained included more favorable repayment terms,[25] such as reduced interest payments, waiver of late fees, forgiveness of overdue payments, or "re-aging" of the account.[26] Once the DMP was negotiated, the debtor agreed to make monthly payments to the CCA in the amount of the debtor's monthly obligation under the DMP.[27]

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19. CREDIT RESEARCH CTR., IMPACT OF CREDIT COUNSELING ON SUBSEQUENT BORROWER CREDIT USAGE AND PAYMENT BEHAVIOR MONOGRAPH 36 9 (Mar. 2002), *at* http://www.msb.edu/prog/crc/pdf/M36.pdf. The study considered consistent themes of counseling to be:

> Ways to increase income, . . . decrease household spending, . . . be clear about priorities and pay high priority debt first, keep fewer lines of credit open, reduce debt levels, pay larger amounts on those accounts that have a combination of larger balances and higher interest rates, make consistent and timely monthly payments, adjust or reformat existing accounts through refinancing, seek lower financing options, work with creditors directly to get payments/interest reduced; [r]esolve credit reporting inaccuracies, don't apply for credit just to see if you can get accepted; [a]void accumulating unnecessary inquiries on the credit report, review legal rights and options available, save for upcoming major expenditures.

Id.

20. *See id.* at 3-4; Mark Furletti, *Consumer Credit Counseling: Credit Card Issuer's Perspective*. PAYMENT CENTER F.R.B. OF PHIL., (Sept. 2003), *at* http://www.phil.frb.org/pcc/discussion/Chase_Juniper_CCCS.pdf [hereinafter Furletti] at 5-6.

21. *See* CREDIT RESEARCH CTR., *supra* note 19, at 1.

22. *See* MAJORITY & MINORITY, *supra* note 11, at 2 & 4; *See* CREDIT RESEARCH CTR., *supra* note 19, at 1.

23. *See id.*

24. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 21-22. The rates of concession are maintained as policies by creditors. *Id.*

25. *See* MAJORITY & MINORITY, *supra* note 11, at 2 & 4; *See* CREDIT RESEARCH CTR, *supra* note 19, at 1-2.

26. *See* CREDIT RESEARCH CTR., *supra* note 19, at 1; CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 21. "Re-aging" of a credit card account eliminates delinquencies from a debtor's credit history. *Id.*

27. *See* MAJORITY & MINORITY, *supra* note 11, at 2 & 4.

Traditionally, the debtor only paid small, sometimes voluntary, fees to the CCA.[28] The primary funding for CCAs came from "fair share payments" paid by creditors.[29] The amount of the fair share payment was simply based on a percentage of the funds collected from the debtors.[30] Creditors willingly accepted the costs of concessions and fair share payments because they believed that the combination of the counseling and the DMP would increase the chances of collecting their debts.[31]

As recently as 1993, ninety percent of CCAs in the United States belonged to the National Foundation for Credit Counseling (NFCC), the primary self-regulatory body for CCAs.[32] The NFCC imposed regulations upon their member institutions including: (1) requiring a certain percentage of assets to be allocated to informational programs, (2) requiring comprehensive counseling, and (3) limiting fees.[33] Membership in the NFCC was nearly universal because creditors more readily negotiated with NFCC members.[34] Creditors maintained oversight of CCAs through membership on the NFCC national board of directors.[35]

III. RECENT ENTRANTS TO CREDIT COUNSELING AND CHANGING PRACTICES

A. An End to Self-Regulation

In 1994, numerous non-member CCAs sued the NFCC on antitrust claims.[36] The NFCC settled the suit and agreed to no longer

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28. *See id.* at 2-3.

29. *See id.* at 25; CREDIT RESEARCH CTR, *supra* note 19, at 2.

30. *See* MAJORITY & MINORITY, *supra* note 11, at 2. Fair Share payments are typically paid based upon the "aggregate debtor payments managed by a CCA." *Id. See generally* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 10. In 2002, the average percentage was 8%. *Id.*

31. *See* MAJORITY & MINORITY, *supra* note 11, at 2.

32. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 7.

33. *See* MAJORITY & MINORITY, *supra* note 11, at 24. On the matter of fees, NFCC members are forbidden from refusing services on the grounds of inability to pay a fee. *Id.*

34. *See id.* at 2.

35. *See id.* at 26.

36. Garden State Consumer Credit Counseling v. Nat'l Foundation for Consumer Credit, No. 94-1141 (E.D.N.Y, filed Mar. 14, 1994); *See also* In re: Consumer Credit Counseling Services Antitrust Litigation, No. 97-1741, 1997 W.L. 755019 (D.D.C.);

grant creditors seats on its national board of directors.[37] As a result, there was no longer an incentive for CCAs to join the NFCC.[38] Without this self-regulation CCAs have evolved in a regulatory vacuum.[39]

Propelled by increasing consumer debt over the past ten years,[40] the demand for credit counseling services grew dramatically.[41] As a result, the number of CCAs skyrocketed, but these Recent Entrants refused to adopt the traditional NFCC practices.[42] From 1993 to 2003 participation by CCAs in the NFCC declined from 90% to approximately 15%.[43]

B. Focus on DMPs

Unlike traditional CCAs, Recent Entrants market DMPs[44] and offer no actual counseling.[45] Evidence shows the counseling programs dramatically increase the chances that payments will be made to the

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MAJORITY & MINORITY, *supra* note 11, at 26. The NFCC changed its name from the National Foundation for Consumer Credit to the National Foundation for Credit Counseling in 2000. *Non-Profit Credit Counseling Organizations: Hearing before the House Subcomm. on Oversight*, 108th Cong. 44 (2003) [hereinafter *House Hearing*] (statement of W. Patrick Boisclair, Chairman of Board of Trustees, NFCC).

37. *See* MAJORITY & MINORITY, *supra* note 11, at 26.

38. *See id.* at 26; CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 7.

39. *Id.*

40. *See* MAJORITY & MINORITY, *supra* note 11, at 1. "Consumer debt has more than doubled in the past ten years. The nation's credit card debt is currently $735 billion—an average of nearly $7,000 per household." *Id.*

41. *See* CREDIT RESEARCH CTR., *supra* note 19, at 1. NFCC member agencies have more then doubled their responses to debtors between 1990 and 2000. *Id.* In 2000, NFCC members counseled over 880,000 new clients. *Id.* In 2000, over two million Americans pursued credit counseling services. *Id.*

42. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 7.

43. *See id.*

44. *See id.* at 20.

45. *See Senate Hearing*, *supra* note 1, at 15 (statement of John Pohlman, Former Employee, Cambridge Credit). Pohlman describes how no other costs were considered in the budgeting. Unlike his prior work in credit counseling where it typically took over an hour to complete counseling, Cambridge expected each call to take ten to fifteen minutes. *Id.* A customer of Cambridge Credit described how he was simply offered a DMP and quoted a price after giving a list of his credit cards and debts. *Id.* at 12-13 (statement of Raymond Schuck, Customer, Cambridge Credit). A former employee of AmeriDebt described being told to limit calls to less then fifteen minutes. *Senate Hearing*, *supra* note 1, at 17-18 (statement of John Paul Allen, Former Employee, AmeriDebt); MAJORITY & MINORITY, *supra* note 11, at 2.

creditor.[46] In fact, the results of this empirical study by the Credit Research Center found that substantive counseling not only increased the tendency of debtors to improve their credit but that the impact is greater for individuals entering with greater credit problems.[47] The loss of educational services, therefore, undermines a central function of credit counseling.[48]

C. Dispute over Fair Share Payments

Recent Entrants argue that the elimination of counseling is a consequence of creditors reducing fair share payments.[49] While fair share payments have been decreasing,[50] evidence indicates that this is because debtors no longer receive one-on-one counseling from CCAs, and creditors believe that DMPs alone do not yield increased debt collection.[51] Creditors also fear that profit driven CCAs absorb the value of concessions as profits rather than passing these benefits on to the consumers.[52]

Despite the motivations of creditors in decreasing fair share payments, their reduction actually harms traditional CCAs more than Recent Entrants.[53] Traditional CCAs receive smaller fees from debtors while providing costly counseling.[54] With revenue from fair share payments declining and the cost of supplying complete counseling services increasing, many NFCC members are closing their doors.[55]

While reducing fair share payments has been at best a crude instrument by which creditors have responded to concerns about Recent Entrants, the 1994 suit against the NFCC has made creditors leery of

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46. *See* CREDIT RESEARCH CTR., *supra* note 19, at 3-4 & 30.

47. *See id.*

48. *See supra* text accompanying notes 46-47.

49. *See House Hearing*, *supra* note 36, at 77 (statement of W. Michael Barnhart, Coalition for Responsible Credit Practices).

50. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 10.

51. CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 10. "In 2002, one creditor, Household Credit Services, decreased its contribution to three percent for DMPs set up by phone." *Id.;* Furletti, *supra* note 20, at 3.

52. *See* Furletti, *supra* note 20, at 4.

53. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 10-11 & 20-21.

54. *See id.*

55. *See id.* An IRS survey in 1999 found that half of the sampled NFCC members showed deficits and that that thirty percent showed low margins. *Id.*

adopting fair share policies that favor traditional CCAs over Recent Entrants.[56] Some more innovative creditors employ a minimum standards model whereby CCAs must meet certain minimum standards before the CCA receives any fair share payments.[57] Another option for administering fair share payments is a "pay for performance plan."[58] For example, MBNA offers only a two percent fair share payment for new accounts and increases the payments as the account successfully matures.[59] Minimum standards models and pay for performance plans are sound policies because they create incentives for CCAs to ensure successful payments by debtors.[60] This should minimize the enrollment of individuals who would be better advised to declare bankruptcy and might even encourage better individual counseling if Recent Entrants can be convinced of the effectiveness of such educational programs. Unfortunately, creditors are loathe to coordinate common policies because this might subject them to further antitrust claims.[61]

D. Tactics to Market the DMP

Recent Entrants use high pressure boiler room tactics in pushing DMPs.[62] During a Senate hearing, a former Cambridge Credit

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56. *See* Furletti, *supra* note 20, at 6.

57. *See* MAJORITY & MINORITY, *supra* note 11, at 27-28. Bank One for example requires: Accreditation, Certification of counselors, Fees meeting the Bank One Guidelines, and Bank One must approve the marketing of the CCA. *Id.*

58. *See id.* at 26 & 28. "Common ways to measure success rates are (1) retention rate (the length of time a consumer stays on the DMP), (2) declination rate (the number of proposed DMPs declined by the creditor), and (3) a combination of those measures as well as other factors." *Id.*

59. *See id.* at 27-28.

60. *Id.*

61. *See* Furletti, *supra* note 20, at 6.

62. *Senate Hearing*, *supra* note 1, at 12-14 (statement of Raymond Schuck, Customer, Cambridge Credit). Schuck described how he was told to send his initial payment as quickly as possible to be enrolled as soon as possible in the program. It is of course ironic that this first payment did not initiate payments to his creditors but rather this was held until later. *Id.*; *Senate Hearing*, *supra* note 1, at 16 (statement of Jolanta Troy, Customer, AmeriDebt). Jolanta Troy testified that:

> After this call, the counselor called me back . . . four different times. Every time the counselor called, she would tell me how bad my situation was and that I needed to do something about it. This counselor also said that AmeriDebt was a non-profit organization, "like a charity," and that I needed their help. She was very pushy and almost degrading. She made me feel embarrassed and ashamed, but I eventually decided to go on the program.

employee testified that a leader board which ranked employees by their sales was present at the front of the calling room.[63] In fact, many CCAs compensate their DMP sales force on a commission basis.[64] These tactics seem more insidious when one considers the aggressive advertising of non-profit status by CCAs.[65] Furthermore, many CCAs directly lie about the ability of DMPs to take debtors out of debt.[66]

E. Excessive and Unfair Fees

Recent Entrants charge excessive fees for DMPs.[67] For example, Cambridge Credit charges the debtor a monthly charge equal to 10% of the each monthly payment,[68] while NFCC members charge an average monthly fee of $14.00.[69] Recent Entrants also charge excessive setup fees, often holding the entire first payment to the DMP as such.[70] Compared to the $23.09 average setup fee charged by NFCC members, holding the entire first payment represents an exorbitant fee.[71] It should be remembered that many debtors cannot afford to make payments on their consumer debt, much less an additional payment to the CCA in the same month.[72]

Furthermore, many CCAs do not properly explain the practice of holding the first payment,[73] often inciting debtors to prematurely

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Id.

63. *See id.* at 14-16 (statement of John Pohlman, Former Employee, Cambridge Credit).

64. *See id.* at 14-15 (statement of John Pohlman, Former Employee, Cambridge Credit). Counselors earned up to 25% of the initial set up fee among other sales incentives. *Id.*

65. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 26.

66. David Breitkopf, *The FTC Puts Some Heat On Debt-Repair Agencies*, AM. BANKER, May 10, 2004 at 6.

67. *See* MAJORITY & MINORITY, *supra* note 11, at 22-23.

68. *Id.* at 23.

69. *Id.*

70. *See infra* text accompanying notes 71-78.

71. *Senate Hearing*, *supra* note 1, at 12-13 (statement of Raymond Schuck, Customer, Cambridge Credit). Schuck described how his first payment on a $90,000 debt of $2,000 was held without any portion being passed on to his creditors. *Id.* Furthermore, he explained that he had no knowledge of this arrangement. *Id.*; MAJORITY & MINORITY, *supra* note 11, at 27.

72. *Senate Hearing*, *supra* note 1, at 16 (statement of Jolanta Troy, Customer, AmeriDebt).

73. *Senate Hearing*, *supra* note 1, at 15 (statement of John Pohlman, former employee, Cambridge Credit). This practice might likewise be a conscious deception, Pohlman testified, "With the time spent with the consumer so limited, I had little confidence that they understood that the first payment was kept by Cambridge. In fact, I was trained to tell the

cease their regular payments to creditors.[74] In this case, a consumer's debts continue to increase even though DMP payments are dutifully made.[75] This has a compounding effect on consumers, as debts increase and their credit is damaged.[76] Some CCAs even fail to explain to debtors which accounts are covered by the DMP, or that the debtors must contact their creditors to explain the new payment schedule.[77] These errors and miscommunications also result in further failure to pay by the debtor, which similarly undermines the DMP's purpose.[78]

IV. STATE OF THE LAW

A. State Enforcement

In 1963, the United States Supreme Court first upheld a state statute prohibiting credit counseling.[79] Most states now have statutes that regulate credit counseling.[80] These statutes functionally prevent credit counseling by for-profit entities.[81] State statutes typically refer to credit counseling as "debt adjusting"[82] or "debt pooling."[83] Common methods for states to limit credit counseling include: (1) entirely forbidding credit counseling with exceptions for non-profit

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customer, 'I will be faxing you the paperwork – it is very simple and easy to fill out – shouldn't take you ten minutes.' But this was a pressure tactic we were supposed to use." *Id.*

74. *Senate Hearing*, *supra* note 1, at 12-14 (statement of Raymond Schuck, Customer, Cambridge Credit) & 16-17 (statement of Jolanta Troy, Customer, AmeriDebt).

75. *Senate Hearing*, *supra* note 1, at 12-14 (statement of Raymond Schuck, Customer, Cambridge Credit); *Pushed Off the Financial Cliff*, CONSUMER REPORTS, July 2001, *at* http://www.consumerreports.org/main/detail.jsp?CONTENT%3C%3Ecnt_id=85425&FOLDER%3C%3Efolder_id=18151.

76. *Senate Hearing*, *supra* note 1, at 13 (statement of Raymond Schuck, Customer, Cambridge Credit). Schuck described having his credit rating ruined and having the interest rates on his credit cards increased in one case from 9% to 24%. *Id.*

77. *Senate Hearing*, *supra* note 1, at 12-14 (statement of Raymond Schuck, Customer, Cambridge Credit) & 16-17 (statement of Jolanta Troy, Customer, AmeriDebt).

78. *See id.*

79. *See* Ferguson v. Skurpa, 372 U.S. 726 (1963) (upholding Kansas statute that made debt adjusting a misdemeanor, except for as part of the practice of law, against claims that this statute violated the due process clause of the Constitution).

80. *See infra* note 84.

81. *Id.*

82. *See, e.g.*, N.C. GEN. STAT. § 14-424 (2004)

83. *See, e.g.*, 18 PA.C.S. § 7312 (2004)

institutions;[84] (2) forbidding the collection of fees for credit counseling;[85] or (3) a combination of both methods.[86] Many states have statutory exceptions that permit credit counseling by attorneys as part of the practice of law[87] or credit counseling without charging fees.[88] Other states achieve the same outcomes through special licensing requirements.[89]

Though numerous states have sued CCAs for breach of fiduciary duty and unfair and deceptive trade practices in addition to direct claims of operating for-profit,[90] state actions against CCAs have

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84. ARK. CODE ANN. § 5-63-304 & 305(6) (2004) (Arkansas allows nonprofit organizations without fee or charge exceeding actual expenses); DEL. CODE ANN. 11 § 910 (2004) (in Delaware it is a misdemeanor and charitable and non-profits may charge a nominal amount for reimbursement); GA. CODE ANN. § 18-5-2 (2004) (Georgia law creates a misdemeanor and requires that no fee exceed 7.5 percent of the amount paid monthly); HAW. REV. STAT. § 446-2 & 3 (2004) (Hawaii has a penalty of $500 or imprisoned not more than six months and limits the practice to non-profits or charitable institutions charging a nominal sum); IDAHO CODE § 26-2222 (2004) (Idaho only permits practice by § 501(c)(3) non-profits operating with a permit); KY. REV. STAT. ANN. § 380.990 & § 380.03 (2004) (2004) (In Kentucky debt adjusting is misdemeanor with the exception an for § 501(c)(3).); LA. REV. STAT. ANN. 14:331 (2004) (Louisiana has exceptions for non-profits); MASS. GEN. LAWS CH. 180, 4A (2004) (Massachusetts only permitted for non-profits); MINN. STAT. § 332.37(11) (2004) (Minnesota forbids the charging of fees); MO. REV. STAT. § 425.020 & 425.04(5) (2004) (Missouri makes debt adjusting a misdemeanor unless performed without compensation); MONT. CODE ANN. § 31-3-202 & 203(5) (2003) (debt adjusting in Montana is a misdemeanor unless CCA is nonprofit or charitable); N.M. STAT. ANN. § 56-2-2 & 4 (2004) (New Mexico makes debt adjusting a misdemeanor unless performed no compensation); N.C. GEN. STAT. § 14-424 & 426(3) (2004) (North Carolina makes debt adjusting a misdemeanor unless there is no charge to debtor); N.D. CENT. CODE § 13-06-02 & 03 (2003) (North Dakota makes debt adjusting a misdemeanor, but the practice is permitted for non-profits or charitable institutions; 18 PA. CONS. STAT. § 7312 (2004) (Pennsylvania makes debt adjusting a misdemeanor); S.D. CODIFIED LAWS § 22-47-2 & 3 (2004) (South Dakota treats debt adjusting as a misdemeanor but contains a non-profit exception); TENN. CODE ANN. § 39-14-142 (2004) (Tennessee allows $20 dollar maximum monthly fee offered by a non-profit); WASH. REV. CODE § 18.28.010(2)(f) (Washington State only allows debt adjusting by a non-profit); WYO. STAT. ANN. § 33-14-102 (2003).

85. *See supra* note 84.

86. *See supra* note 84.

87. See, e.g., N.D. CENT. CODE § 13-06-03(1) (2003).

88. See, e.g., N.C. GEN. STAT. § 14-426(4) (2004).

89. CONN. GEN. STAT. § 36a-656 (2003) (Connecticut limits the practice to non-profits), MICH. COMP. LAWS § 451.414 (2004) (Michigan licenses are permitted to § 501(c)(3) agencies); NEV. REV. STAT. § 676.320 (2004) (Nevada makes operating without a license a misdemeanor); N.H. REV. STAT. ANN. 399-D:2 (2004) (New Hampshire has a licensing requirement; N.J. STAT. ANN. § 17:16G-6 (2004) (In New Jersey the maximum fee is set by commissioner)); OHIO REV. CODE ANN. 4710.02 (2004) (Ohio has a licensing requirement); R.I. GEN. LAWS § 5-66-2 (2004) (Rhode Island has a licensing requirement).

90. *See* Consumer Credit Counseling Serv. of Florida Gulf Coast, Inc. v. State of Florida, Dept. of Revenue, 742 So. 2d 259 (Fla. Dist. Ct. App. 1997). (A CCAs non-profit petition was denied under state law); *See* MAJORITY & MINORITY, *supra* note 11, at 30.

come only sporadically and have not prevented the broader practice of credit counseling by Recent Entrants.[91] For example, AmeriDebt simply adopted non-profit status in response to a Maryland state action.[92] Cambridge Credit and Brighton Credit Corporation were similarly created to avoid state enforcement.[93] After being forced out of New York by the New York Banking Department, the founders of the Cambridge-Brighton conglomeration, John and Richard Puccio, simply moved their operations to Massachusetts.[94] In Massachusetts, they split their operation between Cambridge Credit, a non-profit which initiates contact with the debtors, and Brighton, a for-profit corporation designed to administer the DMPs.[95]

The Consumer Federation of America and the National Consumer Law Center have advocated for a Uniform Consumer Debt Counseling Act (UCDCA).[96] At over twenty pages, the model act is far more complex than most existing state statutes, and includes a very different approach to regulating credit counseling.[97] Unlike the approach of most current state statutes, the UCDCA does not seek to simply prevent credit counseling by for-profit institutions.[98] The UCDCA instead advocates for far more comprehensive regulation, including requiring the maintenance of bonds,[99] one-on-one counseling,[100] and extensive reporting to consumers.[101] The UCDCA

Suits have been filed by the District of Columbia, Illinois, Minnesota, Missouri, and Texas against AmeriDebt. *Id.* Cambridge Credit Counseling has been sued by Massachusetts and North Carolina. *AG Files Suit Againt Agwan Nonprofit*, BOSTON GLOBE, Apr. 6, 2004 at E2; Press Release, N.C. Attorney General's Office, Cambridge Credit to Give More than One Million Back to N.C. Consumers (Jan. 11, 2005) (on file with the North Carolina Banking Institute Journal); CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 38. The majority of states do not enforce against non-profits that have attained federal non-profit status. *See id.* Many states debt pooling statutes explicitly refer to § 501(c) status. *See e.g.*, IDAHO CODE § 26-2222 (2004).

91. *See* MAJORITY & MINORITY, *supra* note 11, at 30-31. State actions did prevent AmeriDebt from taking on new customers. It should be noted that lawsuits have also been filed by private parties in Illinois, Alabama, California. *Id.*

92. *See id.* at 7.

93. *See id.* at 17-18.

94. *See id.*

95. *See id.*

96. *See* UNIFORM CONSUMER DEBT COUNSELING ACT (Proposed Draft Jan. 2005), *at* http://www.law.upenn. edu/bll/ulc/UCDC/2005JanRedlineDraft.htm.

97. *Id.*

98. *Id.*

99. *See id.* § 12.

100. *See id.* § 14(b)(1).

also institutes criminal penalties for violating the act.[102] While the UCDCA thoroughly regulates credit counseling, it would require broad if not universal adoption to have a decisive effect on Recent Entrants. Currently, the Maryland Debt Management Services Act[103] is the only state statute heavily influenced by the UCDCA.

B. Federal Enforcement

1. The Future of Bankruptcy

Pending bankruptcy legislation makes the fight over credit counseling more contentious.[104] Demand for CCAs is expected to immediately increase by one third if H.R. 975 is passed.[105] This is because Section 106 of the bill requires an individual to participate in a budget analysis with an approved CCA 180 days prior to filing for bankruptcy.[106] Furthermore, discharge under Chapter 7 or 13 would be granted only after an "instructional course concerning personal financial management."[107] Under H.R. 975, both of these functions must be completed with a CCA certified by the United States Bankruptcy Trustee or Administrator.[108] The bill only permits CCAs to participate if: (1) the majority of the board of directors is not employed or benefiting financially from the CCA, (2) fees are reasonable and waived if the debtor is unable to pay, (3) audits are performed annually, (4) adequate counseling is given, including consideration of the current financial condition of the debtor, (5) no commissions are paid to employees based upon outcomes of the counseling, (6) the CCA

101. *See id.* § 14(c).

102. *See id.* § 25.

103. *See* MD. FIN. INST. CODE ANN. § 12-901 to 12-931. Like the UCDCA, the Maryland Debt Management Services Act does not contain a prohibition against the for-profit practice of credit counseling and maintains similar criminal penalties. MD. FIN. INST. CODE ANN. § 12-929.

104. Bankruptcy Abuse Prevention and Consumer Protection Act of 2003, H.R. 975, 108th Cong. (2003). The last major action for H.R. 975 was being placed on the Senate Calendar for the 108th Congress in March of 2003. *Bill Summary and Status for the 108th Congress*, Thomas: Library of Congress, *at* http://thomas.loc.gov/cgi-bin/bdquery/z?d108:H.R.975:.

105. *See Pushed Off the Financial Cliff*, *supra* note 75.

106. H.R. 975 § 106(a).

107. H.R. 975 § 106(b).

108. H.R. 975 § 111.

demonstrates adequate experience in credit counseling, and (7) the CCA must possess adequate finances to offer counseling through the course of repayment.[109] For a CCA, approval to counsel bankruptcy applicants would open a significantly captive market; therefore, it is anticipated that CCAs will fight very hard to be approved by the United States Bankruptcy Trustee. While many CCAs may be willing to change policies in order to comply with the requirements of H.R. 975, a significant market will undoubtedly remain for non-bankruptcy CCAs, as three million debtors went to CCAs last year and only 1.4 million people filed for bankruptcy.[110] Therefore, a significant and growing base of debtors will remain for Recent Entrants to exploit.[111] While H.R. 975 may be helpful in persuading some CCAs to change their policies, bankruptcy reform will not affect Recent Entrants that depend on employing deceptive practices and charging excessive fees.

2. Federal Trade Commission

Congress and federal agencies are actively scrutinizing CCAs.[112] In 2003, the Federal Trade Commission (FTC) filed a claim against non-profit AmeriDebt and its for-profit associate, Debtworks, for violating the disclosure requirements of the Gramm-Leach-Bliley Act.[113] More recently the FTC successfully forced the shutdown of National Consumer Council of Santa Ana for making false assertions that the CCA could make individuals debt-free.[114]

The FTC possesses the power to prohibit unfair and deceptive trade practices,[115] but a central obstacle for the FTC in pursuing claims against CCAs has been statutory protections for non-profits.[116] Under

109. *Id.*

110. *See Pushed Off the Financial Cliff*, *supra* note 75.

111. *See id.*

112. *Senate Hearing*, *supra* note 1; *See House Hearing*, *supra* note 36.

113. *See* FED. TRADE COMM'N, Agency Alleges the Credit Counseling Firm Misrepresents Costs and the Nature of Its Services, F.T.C. (Nov. 19, 2003), *available at* http://www.ftc.gov/opa/2003/11/ameridebt.htm; *See also* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered section of 12 U.S.C.).

114. David Breitkopf, *The FTC Puts Some Heat On Debt-Repair Agencies*, AM. BANKER, May 10, 2004 at 6.

115. 15 U.S.C. § 45(a)(1) (2003).

116. 15 U.S.C. § 44 (2003) (defining corporation as "organized to carry on business for its own profit or that of its members."); *See* Cal. Dental Ass'n v. F.T.C., 526 U.S. 756, 768 (1999) (holding that "Nonprofit entities organized on behalf of for-profit members have

15 U.S.C. § 44[117] the FTC lacks jurisdiction over non-profits unless it can be demonstrated that the entity (1) is "organized to carry on business for its own profit or that of its members;" (2) is a "mere instrumentality" of a for-profit entity; or (3) is part of a "common enterprise" with a for-profit entity.[118]

In addition to facing these hurdles, many of the aggressive practices of Recent Entrants do not constitute unfair or deceptive acts by the CCAs. While certain advertising and assertions by CCAs could qualify as deceptive commercial practices, disproportionately high fees and the failure to provide counseling to consumers do not really implicate claims of unfair and deceptive commercial practices.[119] Finally, successful claims of unfair and deceptive trade practices against one CCA will only curb those specific practices among other CCAs, and will not affect broader profit motive in the industry.

V. ENFORCEMENT THROUGH THE INTERNAL REVENUE SERVICE

Non-profit recognition is critical to CCAs due to the large number of states that prohibit credit counseling by for-profit entities.[120] The Internal Revenue Service (IRS) therefore possesses indirect enforcement powers over CCAs. Recently the IRS has become more aggressive, threatening to revoke the non-profit classification of Recent Entrants and make criminal referrals to the Department of Justice.[121] Currently the IRS seems to hope that the mere threat of action will force compliance by CCAs.[122]

A. Ensuring Counseling Services

Unlike potential enforcement by the FTC, the IRS is in a

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the same capacity and derivatively, at least, the same incentives as for-profit organizations to engage in unfair methods of competition or unfair and deceptive acts.").

117. 15 U.S.C. § 44 (2003).

118. *See* MAJORITY & MINORITY, *supra* note 11, at 32.

119. *See* Am. Fin. Serv. Assoc. v. F.T.C., 767 F.2d 957, 982 (1985). The FTC may not intervene simply because the market is not providing the "best deal." *Id.*

120. *See supra* text accompanying notes 84.

121. *Senate Hearing*, *supra* note 1, at 79 (statement of Mark Everson, Commissioner, IRS).

122. Eileen Ambrose, *IRS May Revoke Nonprofit Status from Some Credit Counseling Agencies*, BALTIMORE SUN, Mar. 25, 2004.

position to ensure that counseling services are offered by CCAs. CCAs obtain non-profit status by complying with § 501(c)(3) of the Internal Revenue Code. Section 501(c)(3) non-profit status is limited to institutions that have a specific list of goals,[123] and tax exempt status may be revoked if it is determined that the non-profit does not exclusively serve one of the § 501(c)(3) permissible functions.[124] CCAs were first officially recognized as being eligible for § 501(c)(3) status in 1969 on the basis of the "educational" benefit they supplied.[125] At that time, the IRS ruled that CCAs should be recognized as § 501(c)(3) organizations because CCAs (1) only collect voluntary contributions and (2) "provid[e] the public with information on budgeting, buying practices, . . . the sound use of consumer credit, [and] . . . instruct[s] the public on subjects useful to the individual and beneficial to the community."[126]

In 1978, the U.S. Tax Court in *Consumer Credit Counseling Service of Alabama, Inc. v. United States*,[127] struck down the IRS

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123. 26 U.S.C. § 501(c)(3) (2003). This section provides that:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual." *Id.*

It should be noted that CCAs also qualify as § 501(c)(4) institutions but that this status offers little protection against consumer protection laws.

See House Hearing, *supra* note 36, at 12 (statement of Mark Everson, Commissioner, IRS).

124. *See* Christian Stewardship Assistance, Inc. v. Comm'n, 70 U.S.T.C. 1037, 1040 (1978).

125. *See* Rev. Rul. 69-441, 1969-2 C.B. 115. The revised rule states that:

> [The agency] provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications. It aids low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans. Under a budget plan, the debtor voluntarily makes fixed payments to the organization. The funds are kept in a trust account and disbursed on a partial payment basis to the creditors, whose approval of the establishment of the plan is obtained by the organization. These services are provided without charge to the debtor. *Id.*

See also House Hearing, *supra* note 36, at 12 (statement of Mark Everson, Commissioner, IRS); Rev. Rul. 69-441, 1969-2 C.B. 115.

126. Rev. Rul. 69-441, 1969-2 C.B. 115.

127. Consumer Credit Counseling Serv. of Ala., Inc. v. U.S., 78-2 U.S.T.C. 9660

mandate that a CCA cannot charge fees and still be eligible for § 501(c)(3) status.[128] The U.S. Tax Court also upheld the use of DMPs by CCAs so long as they were incidental to the primary function of counseling,[129] but Recent Entrants do not even meet this more lenient standard of *Consumer Credit*. [130] Recent Entrants cannot claim that counseling is their primary function when they offer no sincere counseling services.[131] Therefore, the IRS should be able to successfully argue that Recent Entrants must supply counseling services to their clients to continue to qualify as fulfilling an educational purpose.[132]

Currently, the IRS has promised to carefully consider the educational purpose of a CCA in deciding whether to grant § 501(c)(3) status in the future.[133] In fact, the IRS has already created extensive guidelines for organizations applying for § 501(c)(3) exemptions.[134] This alone is not enough to remedy the difficulties in the credit counseling industry. Instead, the IRS should also consider the educational programs of existing CCAs, most centrally counseling, in actively revoking the § 501(c)(3) status and assessing penalties against unscrupulous CCAs.

(D.D.C. 1978); *See also* Credit Counseling Centers of Okla., Inc. v. U.S., 79-2 U.S.T.C. 9468 (1979).

128. *See* Consumer Credit Counseling Serv. of Ala., 78-2 U.S.T.C. at 9660. The central activity of CCAs were truly educational and DMP's were considered adjunct to this service. *Id.* While the IRS originally required CCAs to focus upon lower income clientele and to refrain from charging fees, this requirement was judicially undone in *Consumer Credit Counseling Service of Alabama, Inc. v. United States*. *Id.* The Tax Court was persuaded that § 501(c)(3) did not contain such requirements and held that educational services and the public value of credit counseling were sufficient grounds to establish the non-profit status of CCAs. *Id.; House Hearing*, *supra* note 36, at 13-14 (statement of Mark Everson, Commissioner, IRS). Everson stated the IRS was more carefully scrutinizing CCAs as they seek exemptions. *Id.*

129. *See* Consumer Credit Counseling Serv. of Ala., 78-2 U.S.T.C. at 9660; MAJORITY & MINORITY, *supra* note 11, at 2-3.

130. *See* MAJORITY & MINORITY, *supra* note 11, at 2; *Senate Hearing*, *supra* note 1 , at 15 (statement of John Pohlman, Former Employee, Cambridge Credit).

131. *Senate Hearing*, *supra* note 1, at 15 (statement of John Pohlman, Former Employee, Cambridge Credit).

132. *See* Consumer Credit Counseling Serv. of Ala., 78-2 U.S.T.C. at 9660.

133. Debra Cowen & Debra Kawecki, *Credit Counseling Organizations* (2004), *at* http://www.irs.gov/pub/irs-tege/eotopica04.pdf. The exemption application sheet includes the questions: "State whether your counselors are certified to perform credit repair services. Please indicate the name of the certifying organization and whether it is a federal, state, or private certification organization," and "walk us through a client encounter." *Id.* at 21-23.

134. *See id.*

B. Private Benefit

The IRS may also revoke the non-profit status of any non-profit whose earnings inure to a private party.[135] As noted earlier, many Recent Entrants have avoided state regulation by creating a for-profit company that performs services for the non-profit wing.[136] In one example, the non-profit AmeriDebt merely contacted the debtors, while the for-profit Debtworks administered the DMPs.[137] While it is permissible for a non-profit to employ the services of a for-profit entity, the for-profit cannot possess control over the non-profit.[138] The Cambridge-Brighton conglomeration blatantly violated this probation by having its founders directly control the for-profit and non-profit entities.[139]

Other CCAs have been more subtle by simply creating contracts between the for-profit and the non-profit entity. The use of a contractual obligation as an informal controlling mechanism can also represent an illegitimate private benefit.[140] Fulfillment agreements, such as those employed by AmeriDebt ensure that all CCA functions are performed by a for-profit entity.[141] In *Est of Hawaii v. Commissioner*, the U.S. Tax Court held that a contract, much like those maintained by many Recent Entrants, which functionally binds the non-profit to the for-profit, constitutes grounds for revocation of non-profit status.[142] Additionally, the Tax Court in *Est of Hawaii* found it significant that non-profit status was simply being used to fulfill a contractual obligation.[143] Similarly, by their own admission, Recent Entrants only exist as non-profits to satisfy state law.[144]

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135. *See* United Cancer Council v. Comm'n, 109 U.S.T.C. 326, 382 (1997); 26 C.F.R. §§ 1.501(a)-1(c), (c)(3)-1(d)(1)(i) (2004).

136. *See* MAJORITY & MINORITY, *supra* note 11, at 9.

137. *See id.*

138. *See* Est of Hawaii v. Commissioner, 7 U.S.T.C. 1067 (1979).

139. *See* MAJORITY & MINORITY, *supra* note 11, at 19. To further extract profits from the non-profit operation, the for-profit branch of Cambridge-Brighton sold the rights to its name to the non-profit entity, allowing the non-profit to pay with note. *Id.* at 3 & 19-20.

140. *See* Est of Hawaii, 71 U.S.T.C. at 1080-81.

141. *See* MAJORITY & MINORITY, *supra* note 11, at 9.

142. *See* Est of Hawaii, 71 U.S.T.C. at 1080-81.

143. *Id.* at 1080.

144. *Senate Hearing*, *supra* note 1, at 35 (statement of Matthew Case, CEO, AmeriDebt). During testimony before the Senate Subcommittee on Investigations, Case admitted that non-profit protection was in place for the purpose of complying with state law.

Another advantage of IRS regulation is that it allows for a more measured approach. As an alternative to or in addition to revocation of § 501(c)(3) status, the IRS may pursue intermediate sanctions against Recent Entrants.[145] Any individual "in a position to exercise substantial influence over the affairs of the organization"[146] ("a disqualified person") who receives a private inurement is subject to a twenty-five percent penalty on that benefit or eventually a two-hundred percent fine.[147] This is another powerful but flexible tool of enforcement available to the IRS.

C. Outlook on IRS Enforcement

In fairness, it should be noted that the IRS lacks the resources to pursue all Recent Entrants. In fact, when asked what legislative changes would most benefit the IRS in pursuing unscrupulous CCAs, the Commissioner of the IRS suggested that more money for enforcement was the first priority.[148] With for-profit motives and a questionable structure so closely correlated with unfair practices,[149] it is anticipated that IRS could focus on the most unscrupulous Recent Entrants. Currently the IRS is auditing fifty credit counseling agencies, including nine of the fifteen largest.[150] This will hopefully be the first concerted effort to reform credit counseling.[151]

VI. CONCLUSION

CCAs were first established by creditors as a way to encourage more responsible spending by debtors.[152] Early CCAs were small local institutions focused on counseling.[153] These CCAs sometimes also

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Id.

145. *See* 26 U.S.C. § 4958(c)(1)(A) (2003).

146. *See* 26 U.S.C. § 4958(f)(1)(A) (2003).

147. *See* MAJORITY & MINORITY, *supra* note 11, at 5 (citing 26 U.S.C. § 4958(a)(1), (b)).

148. *See Senate Hearing*, *supra* note 1, at 83-84 (statement of Mark Everson, Commissioner, IRS).

149. *See* CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR., *supra* note 3, at 20.

150. *See* MAJORITY & MINORITY, *supra* note 11, at 31.

151. *Id.* at 31-32.

152. *See supra* note 17 and accompanying text.

153. *See supra* notes 18-19 and accompanying text.

negotiated formal concessions called DMPs.[154] Creditors were willing to make concessions because they believed that DMPs coupled with counseling would increase the chances that the debtor would not declare bankruptcy.[155]

The NFCC, the self-regulating body of CCAs, was sued in 1994 by a small group of non-member CCAs.[156] The NFCC settled the case and lost the capacity to regulate credit counseling.[157] Without regulation and due to growing consumer indebtedness, the number of independent CCAs skyrocketed.[158] These Recent Entrants aggressively market DMPs and offer little or no actual counseling to consumers.[159] Recent Entrants also charge extremely high fees and often deceive consumers about the terms of the DMP.[160]

The question becomes how to regulate CCAs. Almost all states have laws restricting credit counseling.[161] For example, most states only permit credit counseling by non-profit institutions.[162] While this restriction has forced many CCAs to adopt § 501(c)(3) status, Recent Entrants continue to operate with a profit motive.[163] On the federal level, the Senate is currently considering bankruptcy legislation that would require debtors to go through credit counseling before filing for bankruptcy.[164] This legislation places strict requirements on CCAs that offer such counseling. [165] Unfortunately, the growth of consumer debt represents plenty of opportunity for Recent Entrants to find new business without being certified as bankruptcy eligible CCAs.[166]

Also on the Federal level, the FTC faces numerous hurdles in regulating credit counseling.[167] First, the FTC must prove that a non-

154. *See supra* notes 20-24 and accompanying text.
155. *See supra* notes 30-31 and accompanying text.
156. *See supra* notes 32-37 and accompanying text.
157. *See supra* note 39 and accompanying text.
158. *See supra* notes 40-43 and accompanying text.
159. *See supra* notes 44-66 and accompanying text.
160. *See supra* notes 67-69 and accompanying text.
161. *See supra* notes 79-83 and accompanying text.
162. *See supra* note 84 and accompanying text.
163. *See supra* notes 87-103 and accompanying text.
164. *See supra* notes 104-07 and accompanying text.
165. *See supra* notes 108-09 and accompanying text.
166. *See supra* notes 110-11 and accompanying text.
167. *See supra* notes 112-15 and accompanying text.

profit status is somehow a sham.[168] Additionally, the FTC cannot base claims simply on the grounds of excessive fees or profit motive.[169]

The best opportunity under current law to effectively regulate credit counseling exists with the IRS.[170] Because CCAs must be non-profits in order to operate under state law, the IRS is in a position to regulate CCAs.[171] Under current precedent, in order to organize as a § 501(c)(3) a CCA must be operating exclusively for an educational purpose.[172] The IRS may therefore seek revocation of CCAs that offer inadequate counseling services.[173] The IRS can also seek the revocation of § 501(c)(3) status for CCAs that are structured for private inurement.[174] Recent Entrants violate this inurement restriction by maintaining contracts that bind the CCAs to for-profit entities.[175] Finally, the IRS has the flexibility to fine private parties who have received these private inurements.[176] Given the power, flexibility, and precedent under the U.S. Tax Court, the IRS is in the best position to pursue Recent Entrants that are injuring consumers.

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168. *See supra* notes 116-18 and accompanying text.
169. *See supra* note 119 and accompanying text.
170. *See supra* notes 120-22 and accompanying text.
171. *See supra* notes 123-26 and accompanying text.
172. *See supra* notes 127-29 and accompanying text.
173. *See supra* notes 132-34 and accompanying text.
174. *See supra* notes 135-36 and accompanying text.
175. *See supra* notes 137-44 and accompanying text.
176. *See supra* notes 145-51 and accompanying text.