

Credit Counseling: A Panacea or Just Another Consumer Scam?

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Excessive debts and difficulties making required monthly payments are causing more and more consumers to turn to debt counselors or credit counselors. This demand has given the credit counseling industry an opportunity to exploit these vulnerable consumers. Consumer advocates must understand credit counseling industry practices to recognize unfair and deceptive practices. This article will: 1) give an overview of the credit counseling industry practices and the responses to those practices; 2) describe a typical credit counseling agency scenario; and 3) set out some of the statutes that a credit counseling agency might have violated.

Credit Counseling Industry Practices

The credit counseling industry has existed since the early 1970s.¹ Historically, credit counseling agencies have been non-profit agencies providing valuable services such as credit and budget education. The credit counselors would also refer consumers to other professionals, such as lawyers, or social service agencies for help in emergencies. Rarely, did the credit counseling agencies charge for their services, usually provided during face-to-face meetings.

When appropriate, a credit counseling agency would also offer to help the consumer restructure his existing debt payments through a debt management plan (DMP). DMPs allow consumers to pay the credit counseling agency one consolidated monthly payment for all of their unsecured debts that are included in the plan. After the monthly payment is collected, the agency disburses payments to the creditors in the plan.

The credit counseling industry was actually created by the **creditors** who saw this as an opportunity to recoup their debts.² The creditors would voluntarily pay to the credit counseling agencies a certain percentage of the funds that they received from the debtors. This voluntary payment made by the creditors was generally known as a “fair share” contribution.³ In addition to the “fair share” contribution, the creditors often reduced interest rates and waived certain fees to consumers who paid through a DMP.

Unfortunately, over the years, more and more creditors decided to decrease or eliminate their “fair share” contributions to the credit counseling agencies and to eliminate any interest rate concessions. As a result, the industry saw the rapid growth of a new generation of credit counseling agencies. The new agencies provided little counseling but instead immediately pushed consumers into debt management plans (DMPs) even if that was not appropriate for the consumer. Further, these new credit counseling agencies began to charge consumers for the DMP services.

The newer agencies provide hardly any face-to-face meetings. Instead most of these agencies provide assistance exclusively by telephone or the Internet. In many cases, the agencies are not located in the consumer's state.

In April 2003, the National Consumer Law Center (NCLC) and the Consumer Federation Association (CFA) reported on the number of consumer abuses with the new credit counseling agencies.⁴ The NCLC/CFA Report found that the credit counseling agencies' practices were deceptive and misleading. For example, the agency will tell the consumer that it does not charge for its services. However, the agency will then request the consumer to make a monthly "voluntary contribution" to the agency to cover the costs of maintaining the consumer's account.⁵

Similarly, the agency will tell the consumer that he must make monthly installment payments to have payments disbursed to creditors. In most instances however the agency will keep the consumer's payments until the up-front fees for participating in the DMP are paid and disburse none to the consumer's creditors. As a result, the consumer's debts are being paid late, if at all, and the consumer is incurring late charges.

The NCLC/CFA Report also found that in most cases the credit counseling agencies charge excessive fees. Some agencies charge monthly account maintenance fees (or "voluntary contributions") ranging from \$10 - \$50.⁶ Additionally, initial fees to set up a DMP account ranges from \$300 - \$500.

Finally, the NCLC/CFA Report found that many of the new credit counseling agencies falsely represent themselves as non-profits. The NCLC/CFA report states that some of the credit counseling agencies should not be non-profits because of close connections to for-profit businesses.⁷ Moreover, a number of these agencies were paying the directors and management employees salaries and benefits in excess of \$400,000.⁸

In light of these abuses, the Internal Revenue Service (IRS) has taken steps to ensure that these credit counseling agencies comply with its laws. The IRS has increased its audits of credit counseling agencies and, when warranted, will revoke their tax-exempt status.⁹ The IRS has also issued several consumer alerts on credit counseling agencies.¹⁰

In addition, the federal government and other states are challenging this growing industry and its deceptive practices. For example, the Federal Trade Commission filed a complaint against AmeriDebt, a non-profit credit counseling agency, alleging that it engages in various deceptive practices.¹¹ Also, the attorneys general of Illinois, Missouri, Minnesota and Texas, have sued AmeriDebt alleging similar deceptive and abusive practices, including falsely representing itself as a non-profit when the debt management work is done by a for-profit company.

A Typical Scenario

Typically, the credit counseling agencies solicit consumers for the DMPs through television, radio, print, and internet advertisements. These advertisements make various claims about the services that they provide to consumers and invite the consumers to call for a free consultation. The consumer calls an 800- number and speaks to a customer service representative frequently called “counselors.” In many cases, the person on the other end of that call is in another state.

In the initial telephone call, the agency obtains the consumer’s debt information and immediately advises the consumer to enter into a debt management plan (DMP). A contract is sent to the consumer who then signs the contract without any further explanation and returns the contract by mail.

After the agency receives the signed contract, the agency contacts the consumer and tells the consumer to make the first payment as soon as he can to enroll in the program. In most instances, the agency keeps the consumer’s initial payments until the agency’s up-front fees are paid. In the meantime, the agency does not disburse any payments to the consumer’s creditors. Once the agency establishes a DMP account for the consumer, the agency sends the consumer’s file to its servicing company, which is usually a for-profit agency.

Potential Legal Claims

For consumers who seek credit counseling, current legislation presents a dilemma. Nearly every credit counseling agency has non-profit, tax-exempt status. Non-profit, tax-exempt organizations are exempt from many state and federal consumer protection laws. For credit counselors however, the current legislation presents opportunities for exploitation. There are three statutes that significantly affect the consumer – credit counselor relationship. They are: the Federal Credit Repair Organization Act¹², the Michigan Debt Management Act¹³, and the Michigan Credit Services Protection Act¹⁴.

Federal Credit Repair Organization Act

The most relevant federal statute is the Credit Repair Organization Act (CROA). CROA was enacted to protect consumers from unfair and deceptive business practices by credit repair organizations.¹⁵ It applies to credit repair organizations that provide advice or assistance to any consumer with regard to *any* activity or service that improves a consumer’s credit record.¹⁶ Many credit counseling agencies should fall within this statutory definition.

CROA prohibits the credit repair organizations from making misleading representations about services and engaging in fraud or deception.¹⁷ It also prohibits these organizations from accepting any payment from consumers prior to fully completing all services.¹⁸

CROA however does not apply to tax-exempt 501(c)(3) non-profit organizations.¹⁹ Therefore, the creative consumer advocate should be ready to challenge the agency's non-profit status.

Michigan Debt Management Act

The Debt Management Act regulates credit counseling agencies, although it focuses exclusively on debt management practices.²⁰ The Act requires credit counseling agencies to be licensed in the state of Michigan.²¹ The Act also limits the fees that a licensed agency can charge. It places a \$25 limit on the initial up-front fee.²²

Finally, the Debt Management Act does not provide for an automatic exemption based on the agency's tax-exempt 501(c)(3) status. The Act provides that certain organizations receiving compensation from the government or from tax-exempt foundations may be granted exemption upon a showing of safeguards in the handling of debtor funds and if the exemption is found to be in the public interest.²³ This seems to provide an opportunity for a consumer advocate to challenge the non-profit status of a credit counseling agency.

In light of this Act, a prudent consumer advocate should first visit the website of the Office of Financial and Insurance Services (OFIS)²⁴ to determine whether the credit counseling agency is currently licensed in Michigan. If the agency is not licensed, any contract of debt management services made by the agency is null and void.²⁵

Michigan Credit Services Protection Act

The Michigan Credit Services Protection Act (MCSPA) is applicable if the credit counseling agency is not licensed under the debt management act.²⁶ MCSPA also exempts 501(c)(3) non-profits.²⁷ Again, the creative consumer advocate should be ready to attack the non-profit status.

MCSPA also prohibits the credit services organization from making false or misleading representations about their services and engaging in fraudulent or deceptive practices.²⁸ The most important aspect of MCSPA is that the credit services organizations are not allowed to charge up-front fees. All services must be completed before any fee can be collected.²⁹

Conclusion

Not all credit counseling agencies are unscrupulous. The consumer should be informed when selecting a credit counseling agency. The consumer should make sure that the credit counseling agency offers other services besides DMPs. The consumer advocate should be ready to recognize these deceptive practices and be creative in challenging these practices.

¹ David A. Lander, *Snapshot of an Industry in Turmoil: The Plight of Consumer Debt Counseling*, Consumer Finance Law Quarterly Report, p. 1(Fall 2000).

² *Id.*

³ *Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants*, p. 6, April 2003 Report by National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA).

⁴ *Id.* at 2.

⁵ *Id.* at 2, 17.

⁶ *Id.* at 16.

⁷ *Id.* at 31.

⁸ *Id.* at 32.

⁹ See “IRS Takes Steps to Ensure Credit Counseling Organizations Comply With Requirements for Tax-Exempt Status,” October 2003, available at <http://www.irs.gov/newsroom/article/0,,id=114575,00.html>

¹⁰ See <http://www.irs.gov/newsroom>.

¹¹ *Federal Trade Commission v AmeriDebt Inc., DebtWorks, Inc., Andris Pukke and Pamela Pukke* (D. Md. Filed Nov. 19, 2003). The complaint is available at

<http://www.ftc.gov/os/caselists/0223171/031119compameridebt.pdf>

¹² 15 USC § 1679 et seq.

¹³ MCL 451.411 et seq.

¹⁴ MCL 445.1821 et seq.

¹⁵ 15 USC § 1679 (b)(2).

¹⁶ 15 USC § 1679a (3)(A).

¹⁷ 15 USC § 1679b (a)(3), (4).

¹⁸ 15 USC § 1679b (b).

¹⁹ 15 USC § 1679a (3)(B)(i).

²⁰ Some of the newer credit counseling agencies often state that they offer “debt negotiation or settlement services” instead of “debt management plans”. This is perhaps another attempt to evade state law. Most of the state laws refer to debt management plans only. Debt negotiation or settlement seems to differ from debt management plans only to the extent that the agencies providing debt negotiation and settlement services do not send regular monthly payments to creditors. See NCLC/CFA Report, *supra* at 6 n11. According to the NCLC/CFA Report, these agencies “encourage consumers to pay fees to the negotiation firm and not pay their creditors. These agencies generally maintain debtor funds in separate accounts, holding these funds until the agency believes it can settle the entire debt.” See *id.* Either way you cut it, the agencies are managing the consumers’ debts.

²¹ MCL 451.413.

²² MCL 451.423(1).

²³ MCL 451.414(2).

²⁴ See <http://www.michigan.gov/cis>

²⁵ MCL 451.414.

²⁶ The Michigan Credit Services Protection Act exempts a debt management business licensed under the Debt Management Act. See MCL 445.1822(c)(vii).

²⁷ MCL 445.1822(c)(ix).

²⁸ MCL 445.1823(d), (e).

²⁹ MCL 445.1823(b).