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PROFITEERING IN A NON-PROFIT INDUSTRY: ABUSIVE PRACTICES IN CREDIT COUNSELING

REPORT

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PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

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PROFITEERING IN A NON-PROFIT INDUSTRY: ABUSIVE PRACTICES IN CREDIT COUNSELING

I. INTRODUCTION

In September 2003, the U.S. Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, began an investigation into the credit counseling industry. The investigation focused on new entrants into the industry, the marketing of debt management plans, the relationship between non-profit credit counseling agencies and for-profit service providers, and the quality of the counseling that clients received. The Subcommittee's Majority Staff initiated the investigation at the direction of the Subcommittee's Chairman, Senator Norm Coleman, with the concurrence and support of the Subcommittee Ranking Minority Member, Senator Carl Levin. The information in this report is based on the ensuing bipartisan investigation by the Subcommittee's Majority and Minority staffs.

Credit counseling agencies ("CCAs") have traditionally been non-profit companies that rely upon contributions from creditors and charities and small fees from consumers to cover the operating costs of providing advice, debt counseling, and debt management plans to consumers who have trouble paying their credit card bills. Some new entrants to the industry, however, have developed a completely different business model—a "for-profit model" designed so that their non-profit credit counseling agencies generate massive revenues for for-profit affiliates through advertising, marketing, executive salaries, and any number of other activities other than actual credit counseling. The new model looks to the consumer to provide those revenues.

Many of the new non-profit and for-profit companies are organized and operated to generate profits from an otherwise non-profit industry. Evidence of the new entrants' intention to create profits is indicated in several ways, including: (1) the manner in which the new entrant is organized, (2) the extent of control exercised by a for-profit entity over its non-profit CCA affiliate, and (3) the massive revenues funneled to the for-profit entity from the non-profit agency.

When profit motive is injected into a non-profit industry, it should come as no surprise that harm to consumers will follow. Indeed, the primary effect of the for-profit model has been to corrupt the original purpose of the credit counseling industry—to provide advice, counseling, and education to indebted consumers free of charge or at minimal charge, and place consumers on debt management programs only if they are otherwise unable to pay their debts. Some of the new entrants now practice the reverse—they provide no bona fide education or counseling and place every consumer onto a debt management program at an unreasonable or exorbitant charge.

II. EXECUTIVE SUMMARY

Consumer debt has more than doubled in the past 10 years.[1] The nation's credit card debt is currently $735 billion.[2] The rapid increase in credit card balances is one factor in the corresponding increase in personal bankruptcies. Since 1996, more than one million consumers have filed for bankruptcy each year, with a record 1.66 million new filings in 2003.[3] As Chairman Coleman stated in his opening statement at the hearing entitled *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* March 24, 2004, "The growth in both debt and bankruptcy demonstrates the need for much better financial education. Although the immediate cause of most bankruptcies is a sudden setback such as divorce, serious illness, or unemployment, the amount of debt these individuals carried when faced with this tragic event indicates their poor understanding of credit and finances."

The social need for better financial education is one of the primary reasons why credit counseling has long been recognized as a charitable and educational activity worthy of tax exempt status under Section 501(c)(3) of the U.S. tax code. For the past several decades, consumers in debt regularly turned to the non-profit credit counseling industry for advice and financial education. Consumers who could not afford to make all of their payments often enrolled in a debt management program, which allowed them to consolidate their debts from several credit cards, reduce their monthly payments, and lower their interest rates.

Over the past several years, however, the credit counseling industry has undergone significant changes. The activities of some "new entrants" have resulted in increasing consumer complaints about excessive fees, non-existent education, poor service, and generally being left in worse debt than when they initiated their debt management program. With this in mind, the Subcommittee initiated an investigation to determine the state of the credit counseling industry and whether solutions are available to remedy its problems.

The Subcommittee's investigation included a thorough examination of credit counseling agencies, their for-profit affiliates, major credit card issuers, Federal and state agencies and officials, consumer advocates, and their interrelated relationships. Additionally, current and former credit counselors and CCA clients were interviewed and Subcommittee staff responded to advertisements from various agencies to see what advice was being given. The Subcommittee held a hearing on March 24, 2004 in which the Subcommittee's preliminary findings were disclosed and members of the industry testified.

The hearing illustrated the new entrants' model of credit counseling. High consumer fees and lucrative contracts that benefit the

[1] Eileen Powell, "Consumer Debt More Than Doubles in Decade," *The Washington Times,* January 6, 2004.
[2] *Id.*
[3] The American Bankruptcy Institute, available at *www.abiworld.org.*

related for-profit company characterize this model. The Subcommittee focused on three debt management conglomerates to illustrate the unfriendly consumer practices eviscerating the industry. These conglomerates were DebtWorks and The Ballenger Group, Ascend One-Amerix, and Cambridge-Brighton. The hearing consisted of four panels representing consumers, and former CCA employees, CCAs, their for-profit affiliates, and Federal regulators.

The first panel included two victims of the new entrants' predatory practices. Jolanta Troy testified about her experience with AmeriDebt, Inc. ("AmeriDebt"). AmeriDebt is a very large CCA with multiple class action suits pending against it with the Federal Trade Commission and the attorneys general of multiple states. The second witness was Raymond Schuck, a former client of Cambridge Credit Counseling ("Cambridge"), another large CCA with suits pending from the Attorneys General of Massachusetts and North Carolina. Two former employees of AmeriDebt and Cambridge also testified. These former "counselors" discussed the sales tactics they were instructed to practice in order to convince debt-ridden consumers to sign onto debt management plans ("DMPs") rather than offering financial education or counseling.

The second panel consisted of CCAs known for high-pressure sales of DMPs in conjunction with their operations as part of a for-profit conglomerate. The witnesses included representatives of AmeriDebt, American Financial Solutions ("AFS"), and Cambridge. These non-profit CCAs provided little to no counseling and education to consumers, poor service, and had a controversial relationship with their for-profit affiliates. For contrast, a member of the National Foundation for Credit Counseling ("NFCC"), an association of CCAs still following the "old school" model, testified about its very different approach to credit counseling.

The for-profit affiliates to the above-mentioned CCAs comprised the third panel. The Ballenger Group, Amerix, and Brighton Debt Management Services provide processing services, marketing and advertising, lead generation, and other services to their non-profit CCAs. The Subcommittee found that these for-profit affiliates use their non-profit CCAs to generate significant revenues that are siphoned out of the non-profit CCAs through contracts at above market prices. Through these contracts, the for-profit affiliates exert a great deal of control over the non-profit CCAs by setting minimum rates for DMP sign ups and fee collections.

Completing the hearing, on the fourth panel, was Commissioner Mark Everson of the Internal Revenue Service and Commissioner Thomas Leary of the Federal Trade Commission. Each discussed their agency's actions to address abuses in the credit counseling industry. The Internal Revenue Service announced the implementation of a new program for reviewing the applications of credit counseling agencies for non-profit status. The IRS has also initiated audits of over 50 CCAs. Commissioner Leary discussed the Federal Trade Commission's concerns about the industry and the actions it has taken against AmeriDebt and The Ballenger Group, as well as generally, to protect the American consumer from deceptive and unfair practices. Commissioner Everson stated in his testimony, "Based on the FTC data and our examinations, it appears that some organizations are operating solely on the Internet and are providing debt management and not credit counseling. In many cases, credit counseling services have been replaced by promises to restore favorable credit ratings or to provide commercial debt consolidation loans.” Clearly, something is wrong with the credit counseling industry.

III. OVERVIEW OF THE CREDIT COUNSELING INDUSTRY

A. History of the Credit Counseling Industry

The practice known as “credit counseling” was initiated by creditor banks and credit card companies during the mid-1960s in an effort to stem the growing volume of personal bankruptcies. Most, if not all, of the original CCAs were members of the National Foundation for Credit Counseling (“NFCC”).[4] NFCC member agencies were generally community-based, non-profit organizations that provided a full range of counseling, often in face-to-face meetings with consumers. Trained counselors would advise consumers about how to remedy their current financial problems, counsel them on budget planning, and educate them as to how to avoid falling into debt in the future. These counseling sessions were traditionally one-on-one meetings in which an educated counselor performed a detailed analysis of an individual’s income, expenses, debts, and other budget requirements. A consumer would meet with a counselor more than once and for significant periods of time, often over an hour. After a budget analysis, the counselor might recommend that the consumer readjust his or her budget, utilize a debt management plan, or seek legal assistance, possibly to declare bankruptcy.

From the outset, a popular credit counseling option was the “debt management plan” (“DMP”). In order to initiate a DMP, a consumer would authorize the credit counselor to contact each of the consumer’s unsecured creditors—primarily credit card companies. The counselor would then negotiate with each creditor to lower the consumer’s monthly payment amount, to lower the interest rate, and to waive any outstanding late fees. All of the consumer’s lowered monthly payments were then “consolidated” into a single payment. The consumer would send a single payment to the CCA, which would then distribute payments to each of the consumer’s creditors.

DMPs were prevalent because each party involved—the consumer, the creditor, and the CCA—received a tangible benefit. Consumers got their finances under control and received concessions from their creditors, such as reduced interest rates, waiver of late fees, and forgiveness of overdue payment status. Creditors, rather than taking a loss from a bankruptcy, received all of the principal debt owed by the consumer. The CCA, in return for organizing the DMP, would receive “fair share” payments from the creditor to cover their expenses, salaries, and operational costs. The fair share remittance generally amounted to 12–15% of the payments received by the creditor as a result of the DMP.

This mutually beneficial system operated smoothly for several decades. Some NFCC CCAs charged nominal fees or requested contributions from consumers. Such fees or contributions were used to defray their costs for counseling and initiating and maintaining the

[4] For more information on the NFCC, visit the organization’s website at *www.NFCC.org.*

DMP. Such fees and contributions were small in comparison to the creditor concessions received by the consumer. Today, the fees charged by NFCC CCAs remain minimal. The average initial fee to set up a DMP with a NFCC agency in 2002 was $23.09 and the average monthly maintenance fee was $14.[5]

Growth in consumer credit card debt in the 1990s however, brought many new and aggressive entrants into the credit counseling industry. Since 1994, 1,215 CCAs have applied to the IRS for tax exempt status under Section 501(c)(3).[6] Over 810 of these applicants applied between 2000 and 2003.[7] There are currently 872 active tax-exempt CCAs operating in the United States.[8] Many of these new entrants are not centered around community-based, face-to-face counseling, but rather upon a nationwide, Internet and telephone-based model focused primarily, if not solely, upon DMP enrollment. Many of the new entrants are set up on a for-profit model. The for-profit model is designed to provide the maximum benefit to related for-profit corporations, which enter into contracts with non-profit CCAs to siphon off revenue from the CCA. A common method used by the for-profit entity to collect revenue from the CCA is to set itself up as a "back-office processing company," which contracts to provide data entry and DMP payment processing for the CCA. The Subcommittee found that these contracts are often executed by officers or directors of a CCA who have familial ties or close business relationships with the owners of the for-profit entity. The Subcommittee also found that, in many instances, multiple non-profit CCAs would send processing fees to a single for-profit company, which reaped substantial profits.

B. Current Law Governing the Credit Counseling Industry

CCAs are almost exclusively organized as non-profits under 26 U.S.C. § 501(c)(3). The Credit Repair Organizations Act of 1997 ("CROA") sought to regulate organizations claiming to offer "credit repair services."[9] However, this legislation, which is administered by the Federal Trade Commission ("FTC"), does not apply to Section 501(c)(3) organizations. In fact, the significant increase in tax-exempt CCAs roughly coincides with the passage of CROA, presumably because CCAs organized as non-profits to avoid CROA regulation.[10] Moreover, the provisions of the Federal Trade Commission Act generally do not apply to organizations with tax-exempt status.[11] Section 501(c)(3) status provides protection from scrutiny from many state regulators as well.

Two more recent developments provide additional incentives for companies to enter the credit counseling industry with Section 501(c)(3) status. First, prospective Federal bankruptcy legislation proposes requiring individuals to obtain credit counseling before being eligible to file for bankruptcy. If enacted, most likely the industry would see large increases in persons seeking their services.

[5] NFCC 2002 Member Activity Report, p. 30.

[6] Letter, dated 12/18/03, to the Subcommittee from IRS Commissioner Mark Everson, p. 2 ("Everson letter").

[7] Everson letter, p. 2.

[8] *Id.*

[9] 15 U.S.C. §§ 1679 et. seq.

[10] *Credit Counseling in Crisis,* Consumer Federation of America and the National Consumer Law Center (April 2003).

[11] 15 U.S.C. §§ 41 et. seq.

Second, in the same vein, the recent "Do Not Call" list, established by the FTC to prevent unwanted telephone solicitations, exempts "charitable solicitations." This exemption means CCAs with Section 501(c)(3) status can continue to make telephone solicitations seeking business.

A corporation may qualify for tax-exempt status under Section 501(c)(3) if it is organized and operated exclusively for certain aims, such as charitable, religious, scientific, or educational purposes.[12] No part of the corporation's net earnings may inure to the benefit of any individual or any private shareholder in the corporation.[13] The corporation may not be organized or operated for the benefit of any private interests, such as the interests of the creator, the creator's family, any shareholders of the corporation, or any persons controlled directly or indirectly by such private interests.[14] Organizations claiming tax-exempt status are required to apply for such status by filing an *Application for Recognition for Exemption Under Section 501(c)(3)* with the IRS.[15] IRS agents review each application and recognize or deny tax-exempt status.[16] Once an organization is recognized as having tax-exempt status, it must operate under the requirements of Section 501(c)(3) or risk losing its tax-exempt status. Each year, the tax-exempt organization must file an information return with the IRS detailing its activities, revenues, and expenses.[17]

Credit counseling organizations have been recognized as proper tax-exempt entities for several decades.[18] In 1969, the IRS affirmed that Section 501(c)(3) tax-exempt status was properly granted to an "organization [that] provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications." [19] The ruling noted that such organizations may enroll debtors in "budget plans" where the debtor makes fixed payments to the organization and the organization disburses payments to each of the debtor's creditors.[20] The budget plan services were to be "provided without charge to the debtor." [21] The organization offered education to the public on personal money management through informative tools and provided individual counseling to "low income individuals and families." An aspect of the counseling included the use of debt management plans constructed free of charge. This "free" service was possible because the primary source of funding for the organization was contributions from creditors through "fair share" contributions. Because the organization provided assistance to low income indi-

[12] 26 U.S.C. § 501(c)(3).
[13] *Id.*
[14] IRS Publication 557, *Tax-Exempt Status for Your Organization* (Rev. May 2003), p. 17.
[15] 26 U.S.C. § 508(a).
[16] Everson letter, p. 6.
[17] IRS Publication 557, *supra,* at p. 8.
[18] Providing credit counseling is not an inherently charitable activity. Whether an organization providing credit counseling qualifies for exemption under Section 501(c)(3) depends upon whether the manner in which it provides such counseling serves recognized charitable or educational purposes. Treas. Reg. § 1.501(c)(3)–1(d)(2) provides that the term "charitable" is used in Section 501(c)(3) in its generally accepted legal sense, and includes relief for the poor and distressed or underprivileged. "Educational" as used in Section 501(c)(3) includes instruction of the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)–1(d)(3)(i)(b).
[19] Rev. Rul. 69–441, 1969–2 C.B. 115.
[20] *Id.* at *2–3.
[21] *Id.* at *3.

viduals without charge and provided education to the public, it qualified for tax-exempt status under Section 501(c)(3).

In 1978, the U.S. District Court for the District of Columbia expanded the activities a CCA could perform under Section 501(c)(3) in *Consumer Credit Counseling Service of Alabama v. United States.*[22] The "principal activities" of the CCAs were to, without charge, "provide (a) information to the general public, through the use of speakers, films, and publications, on the subjects of budgeting, buying practices, and the sound use of consumer credit, and (b) counseling on budgeting and the appropriate use of consumer credit to debt-distressed individuals and families."[23] As an "adjunct" to those principal activities, agencies could enroll debtors in a "debt management program" for a "nominal" fee which "may not exceed the sum of $10.00 per month" and which is "waived . . . in instances where its payment would work a financial hardship."[24] Only an "incidental" amount of revenue was to be realized by the agency through the debt management programs.[25]

In this case, the IRS had revoked the exempt status of Credit Counseling Services of Alabama because it did not restrict its services to the poor and it charged a nominal fee for its services. The IRS made this decision even though the agency provided free information on credit to the public and would waive its fee if it created a hardship. When CCCS of Alabama challenged the revocation, the court found that the agency fulfilled charitable purposes by educating the public on subjects useful to the individual and beneficial to the community without any fees.[26] The court found the counseling program was both educational and charitable. The court found that the debt management plans were an integral part of the agency's counseling function and thus were charitable and educational as well. The court also found the DMPs were incidental to the agencies' primary function of education because the counselors spent only 12% of their time on the DMPs and the fees were nominal.

Existing case law indicates that an organization may qualify for Section 501(c)(3) status if it is organized and operated for charitable purposes. The term charitable includes the relief of the distressed or poor.[27] The term also includes educational organizations. The term "educational" includes (1) instruction or training of an individual for the purposes of improving or developing his/her capabilities and (2) instruction of the public on subjects useful and beneficial to the community.[28] Thus the two components of education are individual training and public education. Whether a CCA operates exclusively for charitable purposes depends on the application of the operational test set forth in the IRS code:

> An organization will be regarded as "operated exclusively" for [charitable] purposes only if it engages primarily in activities

[22] No. 78–0081, 1978 U.S. Dist. LEXIS 15942 (D.D.C. Aug. 18, 1978); *see also, Credit Counseling Centers of Oklahoma v. United States,* No. 78–1958, 1979 U.S. Dist. LEXIS 11741 (D.D.C. June 13, 1979).
[23] *Id.* at *3.
[24] *Id.* at *3–4.
[25] *Id.* at *5.
[26] Treas. Reg. § 1.501(c)(3)–1(d)(3)(i)(b).
[27] Treas. Reg. § 1.501(c)(3)–1(d)(2).
[28] *Id.* at (3).

> which accomplish one or more [charitable] purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of a [charitable] purpose.[29]

An organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. To meet this requirement, an organization must establish "that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[30] This prohibition covers "inurement" of earnings to insiders in the form of excessive compensation or other benefits, but it can even apply where the benefit to the private interest is reasonable compensation that is no more than fair market value for the services.[31] An organization may also be considered to serve private interests if it provides a substantial private benefit to outsiders who do not constitute a charitable class.[32]

A charitable organization may operate a trade or business if it furthers an exempt purpose. The regulations under Section 501(c)(3) provide:

> An organization may meet the requirements of Section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. . . . In determining the existence or nonexistence of such primary purpose, all circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.[33]

This test requires determining "whether the [organization's] exempt purpose transcends the profit motive rather than the other way around."[34] In the context of credit counseling, the regulations require determining whether the goal of the claimed educational activity is benefiting the public or simply generating profits for individuals and related businesses.

Tax-exempt CCAs face harsh penalties from the IRS if they fail to confine their activities exclusively to educational and charitable purposes. If a CCA is held to have conferred private benefits or to have violated the prohibition on inurement, its tax-exempt status

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[29] Treas. Reg. § 1.501(c)(3)–1(c)(1).

[30] *Id.* at (ii).

[31] *See, e.g., est of Hawaii v. Commissioner,* 71 T.C. 1067 (1979) ("Nor can we agree with petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether the payments made by petitioner to International were excessive, International and Est, Inc., benefited substantially from the operation of petitioner."); *Church by Mail v. Commissioner,* 765 F. 2d 1387 (9th Cir. 1985).

[32] *See, e.g., American Campaign Academy v. Commissioner,* 92 T.C. 1053, 1064 (1989), in which the Tax Court upheld denial of recognition of exemption under Section 501(c)(3) of an organization that provided training to political campaign workers because the organization's services were provided to persons affiliated with a particular political party.

[33] Treas. Reg. § 1.501(c)(3)–1(e).

[34] *Elisian Guild, Inc. v. United States,* 412 F.2d 121, 124 (1st Cir. 1969), *rev'g* 292 F. Supp. 219 (D. Mass 1968).

is subject to revocation. In lieu of having its exemption revoked, the IRS may instead choose to impose "intermediate sanctions" against the CCA or a related entity. Intermediate sanctions may also be imposed upon certain individuals who are not employed by the CCA but have engaged in an "excess benefit transaction" with the CCA, meaning that the person personally benefited from the CCA through, for example, drawing an excessive salary. An excess benefit transaction is any transaction where a CCA provides an economic benefit to a "disqualified person" that has a greater value than the value of goods or services that the CCA receives from the disqualified person.[35] The tax code provides that, where an individual outside the CCA has substantial influence over the affairs of the CCA and engages in an excess benefit transaction with that CCA, the individual is subject to sanction. The sanction imposed upon such an individual is an excise tax equal to 25% of the excess benefit.[36] Further, if the individual fails to correct the harm caused by the excess benefit transaction within the taxable period, a tax equal to 200% of the excess benefit may be assessed against the individual.[37]

In addition to the serious tax consequences that could be assessed against CCAs and their affiliated for-profit entities, consumer protection laws provide additional protection against improper conduct in the credit counseling industry. The Federal Trade Commission ("FTC") is charged with enforcing Section 5(a) of the FTC Act, which prohibits unfair and deceptive acts or practices in or affecting commerce.[38] Although the FTC generally lacks jurisdiction to enforce consumer protection laws against bona fide non-profits, it may assert jurisdiction over a CCA if the FTC can demonstrate that the CCA is "organized to carry on business for its own profit or that of its members," that it is a "mere instrumentality" of a for-profit entity, or that it is operating within a "common enterprise" with one or more for-profit entities.[39]

The Subcommittee has uncovered alarming abuses of the preceding regulations by three credit counseling conglomerates, as described in the following section.

IV. DEBTWORKS, AMERIX, AND CAMBRIDGE: THREE CASE STUDIES

As noted above, the "traditional" CCA model has been in operation for several decades. This model was generally a community-based, modest operation with minimal overhead and expenses. There were no large fees, no large executive salaries, no high-priced advertising blitzes, and no expensive marketing campaigns. Day-to-day operations were characterized by face-to-face meetings between consumers and credit counselors that lasted in some cases for several hours. If a consumer enrolled in a DMP, the employees of the CCA would negotiate with the consumer's various creditors,

[35] 26 U.S.C. § 4958(c)(1)(A). A "disqualified person" is someone who, at any time during the 5 years preceding an excess benefit transaction, was "in a position to exercise substantial influence over the affairs of the organization."
[36] 26 U.S.C. § 4958(a)(1).
[37] *Id.* at (b).
[38] 15 U.S.C. § 45(a).
[39] 15 U.S.C. § 44; *Sunshine Art Studios, Inc. v. FTC,* 481 F.2d 1171 (1st Cir. 1973); *Delaware Watch Co. v. FTC,* 332 F.2d 745 (2d Cir. 1964).

set up the plan, and distribute payments to the creditors until the consumer's debts were paid in full. The traditional CCA did not "outsource" any of its essential functions to for-profit companies, and millions of dollars did not flow through the CCA to for-profit companies.

The "new" CCA model has modified or even reversed the practices of the traditional CCA. The new model is characterized by high consumer fees and lucrative contracts that benefit related for-profit companies. The revenue generated through DMPs is seldom spent on improving or expanding education or counseling, but rather on advertising, marketing, and other activities unrelated to assisting consumers with their financial problems. Although there are likely scores of such new CCAs currently operating, this Report focuses on the following three major debt management groups: (1) DebtWorks and The Ballenger Group conglomerate, (2) the Ascend One-Amerix conglomerate, and (3) the Cambridge-Brighton conglomerate.

A. DebtWorks and The Ballenger Group Conglomerate

The first case study examines DebtWorks, Inc. ("DebtWorks"), later purchased by The Ballenger Group, LLC ("Ballenger"), which provides DMP processing services to 11 non-profit CCAs, including (1) AmeriDebt, Inc. ("AmeriDebt"), (2) A Better Way Credit Counseling, Inc. ("A Better Way"), (3) CrediCure, (4) Debticated Consumer Counseling, Inc. ("Debticated"), (5) Debtscape, Inc. ("Debtscape"), (6) DebtServe, Inc. ("DebtServe"), (7) Fairstream, Inc. ("Fairstream"), (8) Mason Credit Counseling ("Mason"), (9) Nexum Credit Counseling, Inc. ("Nexum"), (10) The Credit Network, Inc. ("The Credit Network"), and (11) Visual Credit Counseling ("Visual"). The aggregate consumer debt managed by those 11 CCAs has exceeded $2.5 billion.[40]

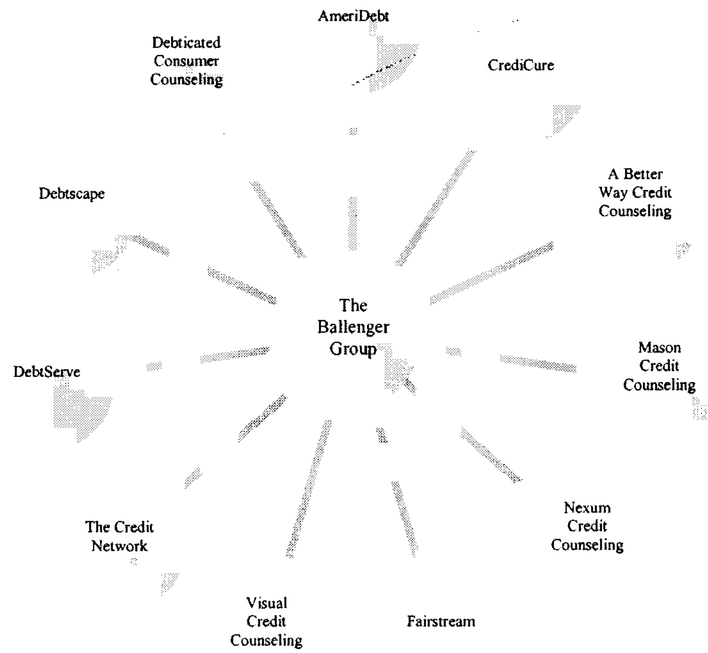
(1) Formation of DebtWorks and The Ballenger Group Conglomerate

DebtWorks was organized by Andris Pukke and his wife Pamela Pukke (also known as Pamela Schuster). Andris Pukke entered the credit counseling industry by organizing and operating a for-profit CCA in Gaithersburg, Maryland, called Consumer Debt Resources.[41] In 1996, after the State of Maryland ordered Consumer Debt Resources to cease operations because it was a for-profit company, it began to wind down its affairs. At that same time, however, Pamela Pukke was organizing a non-profit CCA—AmeriDebt—Pamela Pukke acted as vice president, secretary, and director of the new CCA.[42] Although not listed as an officer or director, Mr. Pukke regularly held himself out to be the president of AmeriDebt.[43]

After operating as a non-profit CCA for approximately 3 years, AmeriDebt decided to "spin off" its DMP processing function and turn it into a for-profit entity called DebtWorks, which was wholly

[40] Letter from Ballenger to Subcommittee, dated 11/26/03, at Exhibit A.
[41] Subcommittee interview of Ballenger representatives (3/12/04).
[42] Articles of Incorporation, dated 12/23/96 (originally named Consumer Counseling Services, Inc.); AmeriDebt Form 1023, dated 3/19/97.
[43] Subcommittee interview of Ballenger representatives (3/12/04).

owned and controlled by Mr. Pukke.[44] DebtWorks was incorporated on July 21, 1999, purchased certain assets of AmeriDebt on September 1, 1999, and signed its first contract with AmeriDebt to provide DMP processing on the same day.[45] AmeriDebt simply moved its DMP enrollment employees to a building next door while the DMP processing function (DebtWorks) remained in AmeriDebt's original office space.[46] AmeriDebt also opened "branch" DMP enrollment locations in New York and Florida. AmeriDebt was initially DebtWorks' sole client, but that was soon to change as AmeriDebt officers, directors, and employees fanned out to form multiple CCAs, each of which subsequently contracted with DebtWorks for DMP processing services.



Most or all of the 11 non-profit DebtWorks CCAs were organized by insiders of AmeriDebt or by friends of Mr. Pukke, including: (1) Edward Catsos, the managing director of AmeriDebt's Florida office and who also organized DebtServe;[47] (2) Edward's brother, James Catsos, who had served as AmeriDebt's secretary and formed Debticated with Mr. Pukke's brother, Eriks;[48] (3) Andrew Smith, who served as interim president for AmeriDebt and formed Fairstream; (4) William Sargent, an AmeriDebt counseling man-

[44] Articles of Incorporation of DebtWorks, Inc., Bates DWS 001538–1541.

[45] *Id.;* Asset Purchase Agreement between AmeriDebt and DebtWorks, dated 9/1/99, Bates DWS 001526–1535; Fulfillment Agreement between AmeriDebt and DebtWorks, dated 9/1/99. AmeriDebt asserts that a "disinterested board" at AmeriDebt chose DebtWorks to be AmeriDebt's DMP processor after reviewing several bids from other entities. Subcommittee interview of AmeriDebt representative (2/27/04).

[46] Subcommittee interview of AmeriDebt representative (2/27/04).

[47] *Id.*

[48] *Id.*

ager who formed Debtscape;[49] (5) Jeffrey Formulak and Richard Brennan, respectively vice president and general counsel of AmeriDebt who currently operate CrediCure;[50] and, (6) Harold Patrie, an AmeriDebt counseling manager, who formed The Credit Network.[51] Matthew Case, the current chief operating officer of AmeriDebt and long time family friend of Mr. Pukke, acted as president of The Credit Network prior to his employment with AmeriDebt.[52] This proliferation of CCAs served both the interests of DebtWorks and the various former AmeriDebt employees: DebtWorks was affiliated with a larger number of CCAs and could therefore capture a larger market share of the DMP enrollment business, while the former AmeriDebt employees apparently paid themselves higher salaries from their CCAs than they had received at AmeriDebt.[53]

The Subcommittee investigation uncovered significant evidence that these CCAs formed a common enterprise. Spirer & Goldberg, P.C., a law firm with a long-time relationship with Mr. Pukke, filed the Section 501(c)(3) applications for almost every CCA in the current conglomerate, including AmeriDebt, A Better Way, Mason, Nexum, Visual, The Credit Network, and Debticated. Moreover, in its application to the IRS, Mason listed its billing address as 12850 Middlebrook Road in Germantown, Maryland—the address of DebtWorks. In addition, some of these CCAs, such as Debticated, signed a contract with DebtWorks before they were even granted non-profit status.[54] At least two CCAs—A Better Way and Visual—received "start-up" loans from Infinity Resources Group, Inc. ("Infinity Resources"), a private lending institution wholly owned and operated by Mr. Pukke.[55] None of the Section 501(c)(3) applications filed with the IRS by the new CCAs mentioned the fact that the applicant CCA intended to contract with DebtWorks for processing services, although each such CCA did.

At the end of 2002, Mr. Pukke formed Ballenger for the purpose of purchasing the operating assets—the right to service DMP accounts—from DebtWorks.[56] The DebtWorks managers then teamed with industry outsiders to execute a management buyout from Mr. Pukke for $43 million, financed with cash and a promissory note. Ballenger still owes Mr. Pukke and DebtWorks more than $37 million on this promissory note.[57]

Since DebtWorks and The Ballenger transaction, Ballenger has continued the practice of assisting with the organization of CCAs. For example, both Debtserve and Fairstream obtained start-up capital of $250,000 by way of a loan, which Ballenger signed as a secondary guarantor.[58] In addition, both Debtserve and Fairstream

[49] *Id.*, AmeriDebt 1998 Form 990, p. 7.
[50] Subcommittee interview of CrediCure representatives (4/7/04).
[51] *Id.; see also* AmeriDebt 1998 Form 990, p. 7.
[52] Deed of Lease Agreement for The Credit Network, dated 5/13/99.
[53] For example, Eriks Pukke made approximately $51,000 as an AmeriDebt counseling manager, but makes $85,000 as president of Debticated. AmeriDebt 1997 Form 990, p. 7; Debticated 2002 Form 990, p. 4.
[54] Fulfillment Agreement between Debticated and DebtWorks (8/1/00); Letter from IRS granting Section 501(c)(3) status to Debticated (8/16/00).
[55] *See, e.g.,* A Better Way 2000 Form 990, indicating loan of $150,000 from Infinity Resources.
[56] Subcommittee interviews of Ballenger representatives (1/15/04 and 3/12/04).
[57] *Id.*
[58] Subcommittee interview of Ballenger representatives (3/12/04).

were extended a functional line of credit by Ballenger for remittance of initial payments that were due to Ballenger.[59]

(2) Control of the Affiliated Credit Counseling Agencies

DebtWorks exercised control of its affiliated CCAs through certain contracts, termed "Fulfillment Agreements," with each CCA. Basically, the Fulfillment Agreements contracted all functions of the CCAs to DebtWorks except for the actual enrollment of consumers into DMPs: "DebtWorks shall perform all fulfillment, back-office, and customer relations services for budget plan clients of [the CCA], with the exception of intake and counseling services."[60] In effect, the CCA served as a mere "call center" from which consumers could be enrolled into DMPs. All operations from that point forward were contractually turned over to DebtWorks.

After Mr. Pukke sold the DMP portfolio of DebtWorks to Ballenger, Ballenger added a new term to the Fulfillment Agreements that conferred additional control over the CCAs. Specifically, Ballenger added a term that charged each CCA a standard fee of $50 for each new DMP enrollment, and an additional $25 per month for each active DMP.[61] However, if the CCA could not for some reason obtain the standard fee from the consumer, Ballenger required a minimum $20 start-up fee and a minimum $10 monthly fee for each DMP. As a result, each CCA was contractually required to pay Ballenger for each DMP that it initiated and maintained. Each CCA was therefore required to generate income from its consumers or be considered in breach, regardless of the fact that the income it generated from consumers supposedly consisted solely of "voluntary" contributions. The result was that Ballenger required each non-profit CCA to pay it for DMP enrollment and maintenance, even if a new DMP generated no revenue for the CCA. Such control over the CCA's revenue limited the CCA's ability to direct funding toward counseling, education, or other matters.

Other provisions in the Fulfillment Agreement further demonstrated Ballenger's control over its CCAs. For example, Ballenger required exclusive rights to each CCA's consumer trust accounts and reserved the right to withdraw funds electronically as well as draw checks on those accounts. In fact, if the CCA itself accessed its account, it was deemed a breach of the agreement subject to termination and entitled Ballenger to "liquidated damages."[62] Another provision in the Fulfillment Agreement allowed Ballenger to determine, by its sole discretion, that (1) a CCA was in breach of the agreement, and (2) if not cured within 30 days, Ballenger may transfer the CCA's DMPs to another CCA serviced by Ballenger.[63] Thus a consumer that signed up for a DMP with a particular CCA could be transferred to another CCA of Ballenger's choice without consulting the consumer. In effect, Ballenger had total control over the DMP once established.

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[59] *Id.*
[60] *See, e.g.,* Fulfillment Agreement between DebtWorks and Mason, dated September 6, 2001.
[61] *Id.* at ¶ 4.1.
[62] *Id.* at ¶ 2.3.
[63] *Id.* at ¶ 6.4.2.

(3) Private Benefits to the For-Profit Corporations

DebtWorks reported gross revenues of $2,160,100 in 1999, $15,411,072 in 2000, $38,066,044 in 2001, and $53,117,661 in 2002.[64] These figures document a 2359% increase in gross revenues over 3 years. In all, between 1999 and 2002, DebtWorks obtained nearly $109 million in gross revenues from its "non-profit" CCA affiliates. Even if those revenues were realized by DebtWorks through arms-length transactions at fair market value, the evidence suggests that the DebtWorks CCAs are not operating exclusively for exempt purposes, and therefore, may be in violation of tax regulations because they are providing excess benefits.[65] If the revenues received by DebtWorks from their affiliated CCAs were the result of excess benefit transactions, then intermediate sanctions may be warranted.[66]

Servicing the DebtWorks portfolio has continued to be lucrative for Ballenger since its transaction with DebtWorks. In 2003, Ballenger realized gross receipts of $37,390,906.[67] Ballenger is owed an additional $10.7 million from affiliated CCAs, most of which are in arrears. Like DebtWorks' revenue, all of the revenue received by Ballenger comes from consumers who enroll in DMPs through the "non-profit" CCAs.

Mr. Pukke also continues to profit from Ballenger's CCAs by offering consumers debt consolidation loans through his company Infinity Resources. Several of the current Ballenger CCAs operate a program where they refer consumers to Infinity Resources, which charges a fee to process a consumer's loan application and then profits from the interest earned on the loan itself. For example, Eriks Pukke's CCA—Debticated—promotes the Infinity Resources debt consolidation loan as a key component of Debticated's program:

> Debticated, Inc. is the *ONLY* company in the country that offers such a unique and beneficial debt consolidation program.
>
> Our "six month" program has revolutionized the debt consolidation industry by providing clients with the benefits associated with working with a non-profit credit counseling company, combined with the opportunity for a complete debt consolidation loan.
>
> If you successfully complete the [six month] program we will attempt to secure a debt consolidation loan for you. . . . This is the ultimate goal of the program.[68]

This advertisement indicates that the stated goal of Debticated is not to provide credit counseling, education, or debt management, but rather to refer consumers to a for-profit entity for a loan consolidation. Additionally, Debticated is hardly the "only" CCA that offers debt consolidation loans with Infinity Resources: A Better

[64] DebtWorks 1999–2002 Form 1120S, Bates DWS 005411–5510. DebtWorks was allegedly unable to provide the Subcommittee with executed tax returns. This data was therefore taken from its draft returns.
[65] Treas. Reg. § 1.501(c)(3)–1(a), *see also, Private Benefit Under IRC 501(c)(3),* p. 135.
[66] 26 U.S.C. § 4958.
[67] Ballenger Accounts Receivable, Bates 01241.
[68] Debticated promotional materials faxed to a consumer (name withheld) on February 28, 2001 (emphasis in original).

Way, The Credit Network, and AmeriDebt all offer the same service.[69] Mr. Pukke and Infinity Resources have become the subject of a number of legal actions for their treatment of consumers referred to Infinity Resources by AmeriDebt. In addition to several civil lawsuits brought against Infinity Resources, Mr. Pukke pleaded guilty in 1996 to a Federal charge of defrauding consumers by falsely promising to broker debt-consolidation loans while pocketing excessive application fees.[70] Nevertheless, between 1999 and 2002, Infinity Resources reported gross revenues in excess of $8.3 million.[71]

A referral by a non-profit CCA to a for-profit entity for debt consolidation loans does not serve any educational or charitable purpose. Such referral activities, if more than insubstantial, may constitute a private benefit to Infinity Resources that is prohibited under the tax code and could support revocation of the Section 501(c)(3) status of any Ballenger CCA that makes such referrals. If the revenues received by Infinity Resources between 1999 and 2002 were the result of excess benefit transactions, then intermediate sanctions may be warranted.[72]

(4) Harm to Consumers

Consumer Jolanta Troy, who was harmed by AmeriDebt, testified about her experiences at the hearing on March 24, 2004. Ms. Troy was a 46-year-old mother of two children, ages 11 and 16, when she heard an AmeriDebt radio commercial. Ms. Troy had recently been divorced and began accumulating debt soon thereafter. Her job as a behavior specialist consultant working with mentally ill and behaviorally challenged children did not provide her with enough income to repay $30,000 in credit card debt and support her children. Ms. Troy contacted AmeriDebt in 2001, and was informed by Vicky, an AmeriDebt "counselor," about the benefits of enrolling in a DMP. Ms. Troy told Vicky that she wanted to think about whether to sign up for a DMP, but soon thereafter received 3 to 4 additional calls from AmeriDebt, pressuring her to enroll.

Ms. Troy agreed to enroll and was told that her first payment would be $783. She was told to rush the payment by Western Union "so that her bills would be paid on time." Vicky told her that she could make a voluntary contribution at a later date when she was more financially stable. Ms. Troy mailed in her $783 payment, but continued to receive calls from creditors. She then called AmeriDebt to inquire about her account and was informed that AmeriDebt had kept her first payment and had sent nothing to her creditors. Ms. Troy requested a refund and was denied, even after complaining to the Better Business Bureau. Ms. Troy then believed her only option was to declare bankruptcy, which she did later that year. Needless to say, she received no counseling or education from AmeriDebt during any of their telephone conversations.[73]

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[69] A Better Way Form 1023, Tab D, dated January 20, 2000; The Credit Network Form 1023, Tab D, dated September 23 1999; Caroline E. Mayer, "Easing the Credit Crunch?," *The Washington Post,* November 4, 2001.

[70] Caroline E. Mayer, "Easing the Credit Crunch?," *The Washington Post,* November 4, 2001.

[71] Infinity Resources 1999–2002 Form 1120S, Bates DWS 005289–5410. Infinity Resources was allegedly unable to provide the Subcommittee with executed tax returns. This data was therefore taken from its draft returns.

[72] 26 U.S.C. § 4958.

[73] Subcommittee interview with Jolanta Troy (3/15/04).

Ms. Troy's experience with AmeriDebt appears to be all too common. Like most consumers with severe financial problems, Ms. Troy was vulnerable to the sales pitch of a company claiming to be a "non-profit" that would solve all her debt problems. She testified, "The counselor said that AmeriDebt was a non-profit—like a charity—and I needed their help. Because AmeriDebt said it was a non-profit, I thought I could trust them." AmeriDebt counselors preyed on her fears and vulnerabilities with high-pressure sales tactics that were intrusive and often belittling.

At the Subcommittee's hearing, Senator Carl Levin questioned Matthew Case, the President of AmeriDebt, about such tactics. Senator Levin asked Mr. Case about an AmeriDebt script that tells employees how to respond to a consumer that says, "I can't afford a contribution right now but maybe I can afford to contribute later." The AmeriDebt script instructs the counselor to respond with:

> If you can afford to make a monthly payment, you can afford to make a contribution. That contribution is not going into our pocket. It is going to cover the costs of setting you up on the program. Would you rather have that payment go to us to help people like you get out of debt or would you like it to go into the creditor's pocket as extra interest? Would you rather support a non-profit company or help a bank get richer? [74]

Senator Levin asked Mr. Case "If you don't call that pressure on somebody to make a contribution how would you label that?" "I would call it pressure," Mr. Case said.

Other examples of instructing AmeriDebt counselors how to quickly make a "sale" are found in the AmeriDebt employee training manual:

- If you can assume a position of authority, you will find that people give it over to you without resistance. [75]
- Create a sense of urgency, "Your creditors want you to get started as soon as possible. The quicker you get started, the faster you will be out of debt." [76]
- Be prepared! If you can't answer questions or make the right point, it could be the difference in a sale or no sale. [77]

By focusing on the sale of DMPs, the consumer misses valuable counseling and education addressing the source of the consumer's financial problems. Senator Mark Dayton asked Mr. Case at the hearing, "Where is the counseling? What is the content of the counseling?" Mr. Case replied, "Right up front, there is a budget analysis done right away because different people are in different situations." The Subcommittee finds that a simple budget analysis solely to determine if a consumer is a candidate for a DMP fails to meet the charitable purpose required of tax-exempt organizations. In addition, the consumer's desperate state generally makes it easier for

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[74] *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* March 24, 2004, Official Hearing Record, Exhibit No. 14, p. 260.

[75] *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* March 24, 2004, Official Hearing Record, Exhibit No. 12, p. 258.

[76] *Id.*

[77] *Id.*

AmeriDebt, and other companies like it, to persuade consumers to "buy" a DMP at inflated prices with few services. As in Ms. Troy's case, the non-profit status often provides a sense of trustworthiness that lowers the consumer's scrutiny of both the DMP and AmeriDebt.

The Subcommittee's investigation also determined that the fee Ms. Troy was charged bore no relation to the cost of the services that would have been provided to her by AmeriDebt. The initial DMP start-up fee charged by AmeriDebt and the other 10 CCAs serviced by DebtWorks and Ballenger is based upon the consumer's aggregate debt, rather than the actual expense of initiating a DMP. Specifically, the consumer is generally asked to make a contribution equaling 3% of their aggregate debt. For example, if a consumer owes a total of $25,000 the initial "contribution" would be $750 (3% of $25,000). In contrast, the start-up fee at the average NFCC member agency for a consumer who owes $25,000 would be $23.09.[78]

Furthermore, as in the case of Ms. Troy, consumers are often left with the impression that this initial fee amount will be sent to their creditors, when in fact it is retained by the CCA. Ms. Troy testified at the Subcommittee's hearing, "I could not afford to give AmeriDebt almost $800. I thought the money would go to my credit cards to pay down the balances."

Aside from the initial start-up "contribution," Ballenger also charged consumers a monthly DMP maintenance "contribution." Again, the contribution amount was not based upon actual costs or the value of the service to the consumer, but upon the number of credit cards included in the DMP—generally $7 per credit card with a minimum of $20 per month and a maximum of $70 per month. Average monthly fees at NFCC members, in contrast, are $10 per month.

The profit motive of AmeriDebt is also illustrated through its employee management practices. John Paul Allen, a former AmeriDebt "counselor," testified at the hearing, "I should have seen a red flag during my interview with AmeriDebt when I was asked by my interviewers to sell them a stapler. That is really what AmeriDebt is about—sales." AmeriDebt's objectives are evident through management incentives such as bonuses for DMPs both in quantity and quality—the more DMPs signed up and the larger the first up-front payment, the larger the bonus for the counselor.[79] NFCC and AICCCA member CCAs do not allow incentives tied to DMPs, because it gives counselors a motive to place consumers on DMPs instead of just providing counseling or financial education. In fact, Mr. Allen was reprimanded repeatedly for informing his customers that they did not have to pay the "voluntary contribution." Allen testified, "My managers would say 'Think of all the money you could make if you would collect those voluntary contributions.'" When consumers were hesitant to give a contribution, Allen testified, "We were instructed to say things like 'Don't you want us to

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[78] NFCC 2002 Member Activity Report, p. 30.
[79] Subcommittee interview with John Paul Allen (2/21/04).

be around for the next person?' or we would tell them that we were a non-profit and thus subject to audit by the IRS." [80]

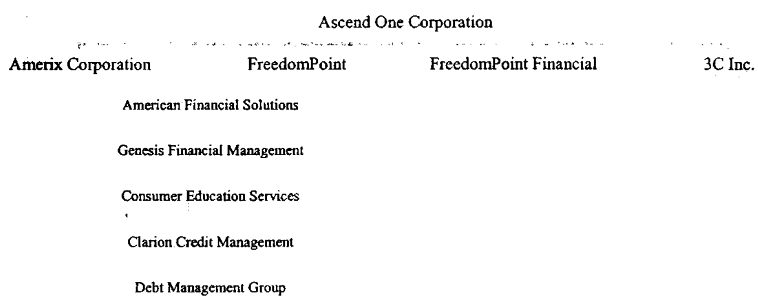
Customer service was another AmeriDebt issue Allen had concerns with.[81] He testified, "I would get calls from people two and three months after I set them up on a plan, complaining that their creditors still had not received a payment." These situations, like Ms. Troy's, are examples of consumers who were unaware AmeriDebt would keep the first payment. Since their creditors did not receive payment, the consumers accrued monthly late fees, and could end up in a worse financial predicament than when they started with AmeriDebt.

B. The Ascend One-Amerix Conglomerate

The second case study examines the Ascend One-Amerix conglomerate. Amerix Corporation ("Amerix") provides DMP processing services for five non-profit CCAs: (1) American Financial Solutions ("AFS"); (2) Genesis Financial Management, Inc. ("Genesis"); (3) Consumer Education Services, Inc. ("CESI"); (4) Clarion Credit Management ("Clarion"); and (5) Debt Management Group. The combined consumer debt under the management of these five CCAs exceed \$4.1 billion.[82]

(1) Formation of the Ascend One-Amerix Conglomerate

Amerix is one of four for-profit companies wholly owned by a holding company called Ascend One Corporation ("Ascend One"), 87% of which is owned by Bernaldo Dancel, the President and CEO of Ascend One.[83] An organizational chart of Ascend One and its affiliates is shown below:



In November 1992, Mr. Dancel founded a non-profit CCA called Genus Credit Management ("Genus"). In October 1996, Mr. Dancel split Genus into two parts, dividing the counseling function and DMP portfolio from the processing function. On October 3, 1996, Mr. Dancel incorporated Amerix as a for-profit business to provide DMP processing services for the Genus DMP portfolio. Mr. Dancel severed his management ties to Genus around that same time in order to run Amerix.

Over the next several years, Amerix facilitated the establishment of several CCAs to serve as sources of revenue for Amerix. Amerix

[80] *Id.*
[81] *Id.*
[82] Amerix Active Clients and Total Debt as of October 2003, Bates AMX 000001.
[83] Stockholders of Ascend One Corporation, Bates AMX 000008.

approached community colleges and universities with the express purpose of proposing a "start-up" CCA.[84] In all, between 1998 and 2003, Amerix made presentations to almost 30 colleges and universities.[85] Under normal circumstances, a new CCA is required to apply to the IRS for Section 501(c)(3) status. The IRS then has the opportunity to review the application of each new CCA and determine whether the applicant qualifies for non-profit status. However, by finding existing Section 501(c)(3) organizations (such as community colleges and universities) that could be used to establish CCAs, Amerix facilitated the establishment of new CCAs while bypassing the scrutiny of the IRS associated with applying for new Section 501(c)(3) status. In this manner, AFS was organized under the Section 501(c)(3) status of the North Seattle Community College Foundation.[86] Other Amerix CCAs such as Clarion and Debt Management Group were similarly organized through pre-existing Section 501(c)(3) entities that did not perform credit counseling services prior to their relationship with Amerix.[87] This practice effectively side-stepped IRS review of these new entrants into the credit counseling industry.

In addition to Amerix (which provided DMP processing services), Ascend One created additional for-profit corporations to serve its CCAs, including FreedomPoint, 3C Inc., and FreedomPoint Financial. FreedomPoint marketed various specialized products such as "prepaid" credit cards and tax settlement products to consumers carrying significant debt.[88] 3C Inc. owned the "CareOne" service mark under which Amerix's CCAs are marketed to the public. FreedomPoint Financial served as a mortgage broker and marketed mortgage-related products to highly indebted consumers. Ascend One also operated a website called "CareOne," which functioned as a referral service, matching inquiring consumers with the closest CCA in the Ascend One conglomerate.

Some of the five CCAs in the Ascend One conglomerate referred consumers to FreedomPoint and FreedomPoint Financial. As noted above, a CCA will not be regarded as tax-exempt "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[89] Referrals by a non-profit CCA to for-profit entities selling credit cards, mortgage brokerage services, and other products are questionable because a non-profit must serve an educational or charitable purpose. Such referral activities, if more than insubstantial, may constitute a private benefit to Ascend One that is prohibited under the tax code and could lead to revocation of the Section 501(c)(3) status of each CCA that makes such referrals.

(2) Control of the Affiliated Credit Counseling Agencies

Although Amerix did not own any of the five CCAs it helped to establish, Amerix exerted control over them through its Service Agreements. The Service Agreements were generally entered into by Amerix and a new CCA as part of the CCA's "start-up" arrange-

[84] Subcommittee interview of Amerix representative (1/30/04).
[85] See list of colleges, universities, and non-profits presented with start-up opportunity, Bates AMX 001732.
[86] Letter from AFS to Subcommittee, dated 11/19/03.
[87] Telephone interview of Clarion representative (3/9/04).
[88] Subcommittee interview of Amerix representative (1/30/04).
[89] Treas. Reg. § 1.501(c)(3)–1(c), *see also, Private Benefit Under IRC 501(c)(3),* pp. 135–39.

ment. A key term in Amerix's Service Agreement required CCAs to enroll 30% of their callers onto a DMP: "During the Term, [the CCA] agrees to maintain an Assist Rate of not less than 30%" where "Assist Rate" is defined as "the ratio of Client Commitments to First Time Calls per Counselor per month." [90] That meant for every 10 calls received by a CCA, at least three must be placed into a DMP or the CCA was considered in breach of contract. Indeed, Amerix has taken legal action against one of its CCAs—Genesis—for its failure to maintain a 30% "assist rate." [91] Such contractual requirements essentially remove the discretion and judgment of a credit counselor as to which consumers they should enroll in DMPs.

In addition to the "assist rate" requirement, additional provisions in the Service Agreements required each DMP to generate a minimum of $30 each month per DMP, termed the "revenue standard." [92] This requirement meant that each CCA was contractually required to find money from some source for each DMP to meet the "revenue standard" in their Service Agreement. Each CCA was therefore required to generate income from its consumers or be considered in breach, regardless of the fact that all income generated from consumers was supposedly "voluntary."

The control granted to Amerix through the "assist rate" and "revenue standard" provisions indicates that Amerix's CCAs may be operating for a private, rather than public, purpose. Control of a non-profit by a for-profit is not permitted under the Internal Revenue Code due to the potential for abuse of the non-profit agency by the for-profit corporation. If a CCA "is closely controlled . . . by . . . a for-profit management company that operates with a great amount of autonomy" then the CCA must establish that the CCA is not organized or operated for the benefit of private interests, according to the IRS.[93] This analysis is called the "operational test" and is usually conducted during the Section 501(c)(3) application process. Amerix's practice of organizing CCAs through existing Section 501(c)(3) entities, however, deprived the IRS of the opportunity to determine the extent of control that Amerix would possess over associated CCAs when first established.

(3) Private Benefits to the For-Profit Corporations

On November 1, 2001, Mr. Dancel sold Genus' DMP portfolio to AFS for $17 million. AFS told the Subcommittee that the sale price of the Genus portfolio was based upon the future revenues that would be generated by the portfolio from fees and fair share payments over a period of several years.[94] AFS, however, was already under contract to pay Amerix for processing services on all of AFS's DMP accounts. Therefore, AFS paid $17 million to Amerix for the DMP portfolio itself, and since that time has paid Amerix out of the revenues generated by the same portfolio. For example, in fiscal year 2001, AFS paid Amerix more than $70 million in processing fees for servicing their DMP portfolio and paid back over

[90] Service Agreement between Amerix and Genesis Financial Management, Inc., dated 9/9/02, ¶ 14. Amerix's other CCAs are also required to carry an Assist Rate of 30%.

[91] *Amerix Corporation v. Genesis Financial Management, Inc.,* No. 16 Y 181 00463 03, Before the American Arbitration Association, filed on 9/2/03.

[92] *See, e.g.,* Service Agreement between Amerix and AFS, dated 10/18/02, ¶ 15.

[93] *Private Benefit Under IRC 501(c)(3),* p. 136.

[94] Subcommittee interview of AFS representative (1/22/04).

$7.4 million of the outstanding loan.[95] Such "double payment" by AFS to Amerix for the same goods and services may constitute an excess benefit transaction under the Internal Revenue Code, and could subject Amerix to excise taxes on any excess benefit.[96]

Amerix and Ascend One have enjoyed great financial benefits from their contracts with the CCAs. Under the terms of Amerix's "Fee Schedule," Amerix was to receive between 50–85% of every dollar received by the CCA. If a consumer contacted an Amerix CCA directly and enrolled in a DMP, then Amerix was to receive 50% of all the non-profit's revenue—enrollment fees, monthly fees, voluntary contributions, and creditor fair share payments—generated by that DMP in exchange for Amerix's processing services.[97] If the consumer contacted and enrolled with the CCA as a result of a referral from Amerix, Amerix was then entitled to 68% of all revenue generated by the DMP.[98] Finally, if a consumer enrolled in a DMP entirely through the "CareOne" website, then Amerix was entitled to 85% of all revenue generated by the DMP.[99] Such pricing levels were based not upon the cost of the processing services provided by Amerix, but rather upon the results of lead generation and marketing activities.

The Service Agreements have, in fact, been lucrative for Amerix. Amerix reported gross revenues of $43,292,677 in 1998, $79,805,084 in 1999, $91,686,853 in 2000, $76,382,167 in 2001, and $95,286,442 in 2002.[100] These figures represent an increase of 120% in gross revenues during this time period. In all, between 1998 and 2002, Amerix received $386 million in gross revenues—all of which was generated by the "non-profit" credit counseling industry. Even if the amounts above had been realized by Amerix through arms-length transactions at fair market value, the absence of any charitable or educational purpose suggests that the Amerix CCAs were not operating exclusively for exempt purposes and therefore may be in violation of tax regulations.[101] If the revenues received by Amerix between 1998 and 2002 were the result of excess benefit transactions, then intermediate sanctions may be warranted against Amerix.[102]

(4) Harm to Consumers

Like DebtWorks CCAs, some Amerix CCAs charged excessive DMP fees. On the other hand, at least two Amerix CCAs—AFS and Debt Management Group—had capped their fees as a result of their membership in the Association of Independent Consumer Credit Counseling Agencies. As such, the harm caused to consumers from unreasonable DMP fees was greatly mitigated at these two CCAs. Even these Amerix CCAs, however, failed consumers by neglecting to provide adequate counseling and education.

[95] AFS 2001 Form 990.
[96] 26 U.S.C. § 4958.
[97] *See, e.g.,* Service Agreement between Amerix and AFS, dated 10/18/02, Schedule B, p. 20.
[98] *Id.*
[99] Subcommittee interview of Genesis representative (2/24/04). The questionable practice of enrolling on a DMP entirely through the Internet is discussed below.
[100] Amerix/Ascend One 1998–2002 Form 1120S, Bates AMX 001452–1730.
[101] Treas. Reg. § 1.501(c)(3)–1(a); *see also, Private Benefit Under IRC 501(c)(3),* p. 135.
[102] 26 U.S.C. § 4958.

Amerix CCAs provided few services to their clients. Through Ascend One's "CareOne" website and links at each of the Amerix CCA websites, a consumer was permitted to enroll in a DMP without a single contact with a credit counselor at any of the five CCAs in the Amerix conglomerate. Since a CCA's charitable status is largely dependent upon its providing educational services, there is no reasonable reading of IRS regulations or case law that permits a CCA to enroll a consumer into a DMP without the consumers interacting with a credit counselor.[103]

Until March 24, 2004, Amerix employed between 30 and 40 "credit counselors" at its location in Columbia, Maryland. These "counselors" provided DMP enrollment services for Amerix's affiliated CCAs when a particular CCA could not at that moment provide services to a consumer. For instance, if a consumer on the East Coast telephoned AFS (located in Seattle) during the morning hours (before AFS was open for business) the caller was routed to Amerix in Maryland. From there, an Amerix "credit counselor" enrolled the consumer in a DMP. Any CCA that knowingly allowed its services to be transferred to a for-profit company, however, may be placing itself in jeopardy of losing its license in states that allow only non-profit agencies to provide credit counseling services.

Amerix stated that the reason why it approached colleges and universities to pitch CCA "start-up" opportunities was because those organizations could educate consumers about their finances.[104] It does not appear, however, that any Amerix CCAs provide classes to consumers on credit practices or budgeting. Genesis told the Subcommittee that it would like to provide counseling and education, but it was unable to do so due to a lack of funds after making the payments required under its Service Agreement with Amerix.[105]

Consumers who actually enrolled in a DMP with AFS were allowed access to a website that had some form of interactive program regarding spending and budgeting.[106] However, AFS did not permit consumers who did not enroll in a DMP to have access to that website even though AFS's non-profit mission is to provide counseling and education to all consumers in need of such help.

AFS told the Subcommittee that, originally, it had high hopes of raising funds for grants and scholarships for students enrolled at North Seattle Community College. On March 18, 2002, shortly after AFS acquired the DMP portfolio of Genus, the CEO of AFS stated that "we're generating more revenue than the foundation ever did. We anticipate giving (North Seattle Community College) in the multimillions of dollars over the next few years" and expected that their next donation would perhaps be in the million-dollar range.[107] Although AFS obtained gross revenues of $75,165,312 during the following fiscal year, it managed to donate only 0.8% of that amount ($581,766) for the college's grants and

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[103] *See, e.g., Consumer Credit Counseling Service of Alabama v. United States,* No. 78–0081, 1978 U.S. Dist. LEXIS 15942 (D.D.C. Aug. 18, 1978).

[104] Subcommittee interview of Amerix representative (1/30/04).

[105] Subcommittee interview of Genesis representative (2/24/04).

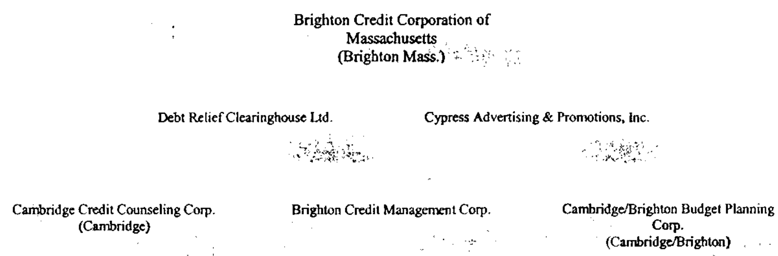
[106] Subcommittee interview of AFS representative (1/22/04).

[107] Jeanne Lang Jones, "A Strong Foundation: $17M Purchase Makes College's Nonprofit Arm the Largest U.S. Credit Counseling Firm," *Puget Sound Business Journal,* March 18, 2002.

scholarships.[108] Ironically, 2 years prior to the AFS-Genus transaction, when AFS had total revenues of just $4,180,059, it donated 16% of that amount ($673,306) in grants and scholarships.[109]

C. The Cambridge-Brighton Conglomerate

The third case study examines the Cambridge-Brighton conglomerate, a complex web of interrelated non-profit and for-profit entities with overlapping directorates and ownership. The Subcommittee's investigation has determined that the operations of the Cambridge-Brighton conglomerate were completely integrated and controlled by brothers John and Richard Puccio. Brighton Debt Management Services, Ltd. ("Brighton DMS") provided DMP processing services to three CCAs: (1) Cambridge Credit Counseling Corp., a non-profit CCA based in Massachusetts; (2) Brighton Credit Management Corp., a for-profit CCA based in Florida; and (3) Cambridge/Brighton Budget Planning Corp., a CCA based in New York with a pending application for Section 501(c)(3) status. Debt Relief Clearinghouse Ltd. was the for-profit marketing arm for the conglomerate, and Cypress Advertising & Promotions, Inc. ("Cypress") provided advertising services.[110] Brighton DMS processed DMP accounts amounting to approximately $900 million of consumer debt.



(1) Formation of the Cambridge-Brighton Conglomerate

The Cambridge-Brighton conglomerate was originally organized by John and Richard Puccio as a for-profit enterprise. Two entities—Cambridge Credit Corporation ("Cambridge Credit") and Brighton Credit Corporation ("Brighton Credit")—were incorporated on April 20, 1993 and October 28, 1993, respectively, as for-profit corporations in New York.[111] The two entities operated out of the same location.[112] Cambridge Credit performed the DMP enrollment function while Brighton Credit performed the DMP processing services.[113] In 1996, after operating for approximately 3 years, the New York Banking Department served a cease and desist order prohibiting the two entities from performing credit counseling services in New York because they were for-profit organizations.[114]

[108] AFS 2002 Form 990, pp. 1–2, Bates AFS 01849–01882.
[109] AFS 2000 Form 990, pp. 1–2.
[110] Subcommittee interview of Cambridge and Brighton DMS representatives (1/20/04).
[111] Cambridge Credit Corporation 1998 Form 1120S, Bates 00297–312; Brighton Credit Corporation 1998 Form 1120S, Bates 00230–243.
[112] *Id.*
[113] Subcommittee interview of Cambridge and Brighton DMS representatives (1/20/04).
[114] *Id.*

The Puccio brothers moved their principal operations to Massachusetts where they formed several new corporations, including Cambridge Credit Counseling Corp. ("Cambridge") and Brighton Credit Corporation of Massachusetts ("Brighton Mass."), later known as Brighton Debt Management Services ("Brighton DMS).[115] As was the case in New York, one entity—Cambridge—was organized to perform the DMP enrollment function while a for-profit entity—Brighton Mass.—was organized to perform the DMP processing and to lease equipment, personnel, software, and provide "other services" to Cambridge.[116] Cambridge applied for Section 501(c)(3) status, which was granted by the IRS on February 12, 1998.[117] In terms of aggregate debt, Cambridge is currently the largest CCA in the Cambridge-Brighton conglomerate.

Despite the cease and desist order from the New York Banking Department, John and Richard Puccio incorporated another New York entity—the non-profit Cambridge/Brighton Budget Planning Corporation ("Cambridge/Brighton")—on December 6, 1996.[118] Cambridge/Brighton operated in the same space previously occupied by Cambridge Credit and Brighton Credit.[119] Like Cambridge, Cambridge/Brighton was under contract with Brighton DMS for all processing services associated with its DMP portfolio. A third CCA was organized as a for-profit corporation in Florida—Brighton Credit Management Corp. ("Brighton Credit Management"). Like Cambridge and Cambridge/Brighton, Brighton Credit Management outsourced all of its DMP processing services to Brighton DMS.

In addition, the Puccio brothers created two other wholly-owned and controlled, for-profit entities that conducted business with the three Cambridge-Brighton CCAs. On July 17, 1996, Cypress Advertising & Promotions, Inc. was created by the Puccios to "procure advertising space/time" for the Cambridge-Brighton CCAs. On January 27, 2000, another for-profit company named Debt Relief Clearinghouse, Ltd. ("Debt Relief") was created by the Puccios to "produce television infomercials" and operate a call center to screen calls for the Cambridge-Brighton CCAs.[120] Both Cypress and Debt Relief operated from the same location as Cambridge/Brighton in New York. Each of the Cambridge-Brighton CCAs paid Debt Relief and Cypress for their services. In sum, although credit counseling is supposedly a "non-profit" industry, only two entities within the Cambridge-Brighton conglomerate were organized as non-profits. All of the revenue realized by the conglomerate was generated by consumers who enrolled in DMPs.

(2) Control of the Affiliated Credit Counseling Agencies

Unlike the Amerix and Ballenger conglomerates that exercised control over their CCAs through the terms of complex service con-

[115] Brighton Mass. 1998 Form 1120S, Bates 00423–435 (Brighton DMS, incorporated on March 21, 2003, was originally incorporated and did business as "Brighton Credit Corporation of Massachusetts").

[116] Cambridge 1997 Form 990, p. 16, Bates 00175; Subcommittee interview of Cambridge and Brighton DMS representatives (1/20/04). Brighton DMS was incorporated on March 21, 2003 to perform DMP processing for all Cambridge-Brighton CCAs.

[117] Letter from IRS to Cambridge, dated 2/12/98, Bates 00002–4.

[118] Cambridge/Brighton Attachment to Form 1023, Bates 20698.

[119] Cambridge/Brighton 2002 Form 990, Bates 20643–65.

[120] Debt Relief 2000 Form 1120S, Bates 00333–340; Cambridge/Brighton Attachment to Form 1023, Bates 20701.

tracts, the principals of Brighton DMS actually owned or controlled each of their three CCAs, Cambridge, Cambridge/Brighton, and Brighton Credit Management, as well as all of the affiliated for-profit entities, Brighton DMS, Debt Relief, Cypress, Cambridge Credit, and Brighton Credit. The Cambridge-Brighton non-profit CCAs (Cambridge and Cambridge/Brighton) were controlled by John and Richard Puccio through their positions as directors, officers, and "key employees." John and Richard Puccio have served as directors of Cambridge since its inception.[121] John Puccio served as president and director of Cambridge/Brighton, and Richard Puccio served as "strategic planner." [122] Additionally, the for-profit entities in the Cambridge-Brighton conglomerate were wholly or collectively owned by John and Richard Puccio:

CAMBRIDGE-BRIGHTON FOR-PROFIT ENTITIES	JOHN PUCCIO (% Ownership)	RICHARD PUCCIO (% Ownership)
Brighton Credit Management [123]	100%	0%
Brighton Mass.[124]	50%	50%
Brighton DMS	50%	50%
Debt Relief [125]	100%	0%
Cypress [126]	100%	0%
Cambridge Credit [127]	50%	50%
Brighton Credit [128]	50%	50%

Through their joint ownership and control of each entity in the Cambridge-Brighton conglomerate, John and Richard Puccio directed all operations and executed all contracts. Almost every possible operation of Cambridge, for example, was contracted out to a related for-profit entity. Cambridge paid Brighton DMS to provide processing for Cambridge's DMP portfolio.[129] Cambridge paid Brighton Mass. to lease its equipment, personnel, and software.[130] Cambridge paid Debt Relief for referrals of consumers [131] and paid Cypress to place advertising.[132] The level of control over the Cambridge-Brighton entities by John and Richard Puccio is illustrated by the fact that some of the entities within the conglomerate conducted millions of dollars of business with one another without any written contract. For example, Brighton Credit Management (the CCA based in Florida) had no contract with Brighton DMS or Debt Relief, but they have conducted business with one another for al-

[121] Cambridge Schedule of Officers and Directors, Bates 01120–01125.
[122] Cambridge/Brighton 2002 Form 990, p. 4, Bates 20646.
[123] Brighton Credit Management 2002 Form 1120S, Schedule K–1.
[124] Subcommittee interview of Cambridge and Brighton DMS representatives (1/20/04); Brighton Mass. 1998 Form 1120S, Bates 00432.
[125] Debt Relief 2000 Form 1120S, Bates 00339.
[126] Cypress 2000 Form 1120S, Bates 00364.
[127] Cambridge Credit 1998 Form 1120S, Bates 00309.
[128] Brighton Credit 1998 Form 1120S, Bates 00240.
[129] Administrative Services Agreement between Cambridge and Brighton DMS, dated 6/1/03.
[130] Cambridge 2001 Form 990, p. 19, Bates 00085.
[131] Client Subscription Services Agreement between Cambridge and Debt Relief, dated 1/1/03.
[132] Advertising Services Agreement between Cambridge and Cypress, dated 4/1/99.

most 3 years. Such control of CCAs by for-profit organizations, whether under contract or not, may violate the "private benefit" prohibitions of the tax code.[133] To illustrate this point, Senator Levin asked Chris Viale, the general manager of Cambridge, at the Subcommittee's hearing, "And the people who control the non-profit also control the for-profit, is that fair to say?" Mr. Viale replied, "Yes, that is fair to say."[134]

(3) Private Benefits to the For-Profit Corporations

The for-profit entities in the Cambridge-Brighton conglomerate have realized great private benefits from the Cambridge-Brighton CCAs they control. These benefits have been realized in two principal ways: (1) the two original New York for-profit entities (Cambridge Credit and Brighton Credit) created and executed a windfall transaction by selling their "intangible assets" to the non-profit Cambridge, and (2) the for-profit entities in the current structure (Brighton DMS, Brighton Mass., Debt Relief, Cambridge Credit, Brighton Credit, and Cypress) have obtained large amounts of money from the non-profits, Cambridge and Cambridge/Brighton, through various service contracts.

When Cambridge was organized in Massachusetts, John and Richard Puccio executed a transaction between Cambridge and their two original New York corporations (Cambridge Credit and Brighton Credit) in which the New York corporations "sold" their "intangible assets" to Cambridge for $14.1 million. These "intangible assets" included "trademarks and goodwill in the marks utilizing 'Cambridge' and 'Brighton' . . . copyrights, general business goodwill, business plans, creditor contacts and relationships, referral source contacts and relationships, business 'know-how,' trade secrets and proprietary information."[135] Since Cambridge had no money (being a newly-formed, non-profit organization), the two New York entities "loaned" Cambridge the necessary $14.1 million. John and Richard Puccio therefore created an artificial, "paper" debt that Cambridge would be obligated to pay back to them for purchasing the "intangible assets" of Cambridge Credit and Brighton Credit. In effect, John and Richard Puccio sold their "business goodwill" and "know-how" to John and Richard Puccio.

As a result of this artificial sale, the Puccios required a non-profit agency (Cambridge) to pay two for-profit corporations (Cambridge Credit and Brighton Credit) $14.1 million plus interest instead of spending that money on improving education, expanding community outreach programs, or any other activity for which Cambridge had been granted tax-exempt status. Cambridge Credit and Brighton Credit have received repayments on the $14.1 million "loan" over the past several years from revenue realized by Cambridge from DMP fees paid by consumers. Although Cambridge has 50 years under the terms of the "loan" to repay the two New York entities, over $11.5 million has been paid back over the past 5 years alone. This $14.1 million transfer may constitute an "excess

[133] *Private Benefit Under IRC 501(c)(3),* pp. 135–39.

[134] John Puccio was invited to testify at the Subcommittee's hearing, however the night before the hearing, Mr. Puccio informed the Subcommittee of health problems that would prevent him from appearing. Mr. Viale, general manager for Cambridge, testified in his place.

[135] Intangible Assets Sale Agreement between Cambridge, Cambridge Credit, and Brighton Credit, dated 11/27/96, Bates 00038–46.

benefit transaction" prohibited by the tax code.[136] Indeed, the IRS may determine that Cambridge was arguably created in part for the purpose of generating $14.1 million for two related for-profit corporations, and may not have been organized exclusively for non-profit purposes.[137]

Beyond the revenue generated by the 1996 "intangible assets" sale, the Subcommittee's investigation determined that Cambridge has generated substantial additional revenues for the other for-profit entities in the Cambridge-Brighton conglomerate. In the Ascend One-Amerix and DebtWorks and Ballenger conglomerates discussed previously, all revenues generated by the CCAs streamed to a single entity. Specifically, in the Ascend One-Amerix conglomerate, all of the revenue from the CCAs streamed to for-profit Amerix, while in DebtWorks and Ballenger conglomerate all revenues streamed to for-profit DebtWorks or Ballenger. In contrast, the revenue streams were more diversified in the Cambridge-Brighton model. The three CCAs (Cambridge, Cambridge/Brighton, and Brighton Credit Management) have distributed their revenues to three or four for-profit entities, all owned and controlled by the Puccio brothers. The bulk of the funds generated by the three CCAs were allocated to Brighton DMS (formerly Brighton Mass.), Debt Relief, and Cypress.

The primary function of for-profit Brighton DMS/Brighton Mass. was to provide DMP processing services, as well as to lease equipment, personnel, software and other goods and services to the Cambridge-Brighton CCAs. While it is not unusual in the credit counseling industry for a CCA to lease equipment, pay for potential leads, or pay for advertising, such payments are usually made as a result of arms-length transactions between unrelated parties at market rates. In the Cambridge-Brighton model, however, the revenues were transferred among related entities.

Since 1998, Brighton DMS/Brighton Mass. has realized gross receipts in excess of $40.5 million.[138] Since 2000, for-profit Debt Relief has produced television "infomercials" and operated a call center to screen calls for the Cambridge-Brighton CCAs. Debt Relief was paid $750 for each consumer it transferred to a CCA and who enrolled in a DMP.[139] Through 2002, Debt Relief referrals have resulted in gross receipts of over $25 million.[140] Cypress has served as an advertising agency for the Cambridge-Brighton conglomerate since 1999, and has realized gross receipts in excess of $6.5 million.[141]

While purportedly operating non-profit, educational entities, the individuals that own and operate the Cambridge-Brighton conglomerate have grown extremely wealthy from their activities. The IRS Form 990s submitted by Cambridge state that Richard and John Puccio each received a salary in 2001 of $624,000 for managing its operations. In addition they received compensation from related organizations of more than $600,000 in that same year. The Sub-

[136] 26 U.S.C. § 4958(c)(1)(A), (f)(1)(A).
[137] Treas. Reg. § 1.501(c)(3)–1(a).
[138] Brighton Mass. 1998–2002 Form 1120S, Bates 00423, 00412, 00400, 00388, and 00375.
[139] *See, e.g.,* Client Subscription Services Agreement between Cambridge and Debt Relief, dated 1/1/02, at ¶ 4(b).
[140] Debt Relief 2000–2002 Form 1120S, Bates 00333, 00324, and 00313.
[141] Cypress 1999–2002 Form 1120S, Bates 00369, 00359, 00350, and 00341.

committee elicited some of this information related to Puccio's salary through testimony at the March hearing from Chris Viale, the general manager. By way of contrast, Senator Mark Pryor asked the representative of a NFCC agency, "What is your salary at your non-profit?" The witness replied, "My annual salary is sixty thousand dollars." As noted above, organizations do not qualify for non-profit status under Federal regulations if they are organized or operated for the benefit of individuals associated with the corporation.

The Subcommittee has been told that the IRS has initiated an audit of Cambridge.[142] As part of that audit, the IRS should determine whether the revenues received by Cambridge Credit and Brighton Credit from the sale of their "intangible assets" amounted to an excess benefit transaction and to what extent, if any, excise taxes should be assessed.[143] Additionally, the IRS should determine whether Cambridge was organized or now operates for private benefit and, if so, whether its Section 501(c)(3) status should be revoked.[144] Finally, the IRS should examine the organization and operation of Cambridge/Brighton, whose Section 501(c)(3) application is currently pending. Since Cambridge/Brighton was designed to operate in a similar manner to Cambridge, the IRS should fully scrutinize its application in order to determine whether it is organized and operated for the public benefit and to ensure that its assets do not inure to the benefit of any private individual.[145]

(4) Harm to Consumers

The Subcommittee interviewed a former client of Cambridge, Raymond Schuck, to evaluate the CCA's services. Mr. Schuck told the Subcommittee that, in the summer of 2001, he had $90,000 in debt distributed among nine credit cards.[146] After hearing about Cambridge on the radio, he called them and spoke with a counselor. Mr. Schuck said that the counselor suggested a debt management plan, and promised him a reduction in interest rates. After answering a list of questions about his various credit cards. Mr. Schuck said that the counselor told him that his monthly payment would be $1,946 and that Cambridge would charge him 10% of his monthly payment for their services, or $194 a month. Mr. Schuck testified at the hearing, "I thought that $194 was high, but I knew very little about the industry and what were appropriate fees. I made the apparently naïve assumption that because it was a non-profit agency, I could trust them."

Mr. Schuck said the counselor told him to hurry and send the first monthly payment to Cambridge to get the program started. He immediately sent in a cashier's check. Although he had already sent in the check to Cambridge, Mr. Schuck said that he started getting calls from some of his creditors asking why he had not made any payments. As in Ms. Troy's situation with AmeriDebt, the creditors told him that they were unaware that he was on a

[142] Subcommittee interview of Cambridge and Brighton DMS representatives (1/20/04).
[143] 26 U.S.C. § 4958.
[144] Treas. Reg. § 1.501(c)(3)–1(a) ("[A]n organization must be both organized and operated exclusively for [tax exempt] purposes" or "it is not exempt."
[145] Treas. Reg. § 1.501(c)(3)–1(c)(2).
[146] Subcommittee interview with Raymond Schuck (2/24/04).

DMP with Cambridge and told him that no payments had been received.

Mr. Schuck said that he called Cambridge to find out what was going on. He said he found it very difficult to contact someone in customer service who could tell him about his account. Mr. Schuck said at the hearing, "Getting in touch with someone who knew about my debt management plan and the status of my payments was an exercise in frustration." When Mr. Schuck did speak with Cambridge, he was informed that the first payment he had sent was a fee for initiating his DMP. He testified, "I was absolutely shocked by this information. Had I known this policy in advance, I would have searched for a different credit counseling agency." Mr. Schuck continued, "I would not have agreed to give Cambridge $2,000 when that money could have gone to my creditors."

Ultimately, Mr. Schuck declared bankruptcy. Mr. Schuck said that he felt that if Cambridge had done a reasonable analysis of his financial circumstances, the proper recommendation would have been to seek legal assistance and declare bankruptcy. In addition, because Cambridge kept his first payment without his knowledge, Mr. Schuck missed payments to nine creditors. As a result, Mr. Schuck's credit rating now bears the consequences of missed and late payments as well as the bankruptcy. Unfortunately, Mr. Schuck's experience was very consistent with current and former clients interviewed by the Subcommittee.

The fee structure of the Cambridge-Brighton CCAs was the highest of any CCA that the Subcommittee investigated.[147] The fees were clearly excessive and bore no relation to the actual expense of initiating and maintaining a DMP. At the hearing, Senator Levin questioned Chris Viale, the general manager of Cambridge, "Shouldn't it [the fee] relate to the services rendered?" Mr. Viale, said "No." Senator Levin went on to ask, "But you keep that first monthly fee regardless of what subsequently comes in terms of benefits to that consumer, is that correct?" Mr. Viale said, "That is correct."

The Subcommittee determined that the initial start-up fee charged to a consumer by the Cambridge-Brighton conglomerate—the "Payment Design Fee"—was typically an amount equal to the consumer's monthly payment. The vast majority of these monthly payments were several hundred dollars, and many were in excess of $1000 or even close to $2000. The result was that the Cambridge-Brighton CCAs routinely charged a consumer $500 or $1000 for merely setting up a DMP. Like AmeriDebt and Ballenger CCAs, the Cambridge-Brighton CCAs retained this fee instead of sending it to creditors. Also like AmeriDebt, the Cambridge-Brighton CCAs too often failed to adequately disclose that fact to clients. Like many other consumers who dealt with Cambridge, Mr. Schuck was not informed that his "Payment Design Fee" of $1,946 would not go to his creditors, but would in fact be kept by Cambridge. The monthly DMP "Program Service Fee" charged by Cambridge-Brighton CCAs was also high. The amount had no relation to Cam-

[147] Unfortunately, Cambridge's fee schedule is not unique in the industry. The Subcommittee's investigation identified several other CCAs who charged an initial fee equal to one month's payment, including Express Consolidation, Inc. of Delray Beach, Florida, and CreditCare Credit Counseling, Inc. of Boca Raton, Florida.

bridge's actual expenses but was instead set at 10% of the monthly DMP payment. Therefore, a consumer who was already paying an $800 monthly payment would also be required to pay an $80 maintenance fee each and every month. By contrast, the average NFCC agency's monthly DMP maintenance fee in 2002 was $14.[148]

A related problem uncovered by the Subcommittee is that the initial 10% fee does not reflect payment for actual services rendered. Cambridge gets the "Payment Design Fee" (10% of total debt) upfront (as well as their monthly service fee). However, Chris Viale testified at the Subcommittee's hearing that, although its plans are designed to last 60 months, "The average length of time for a consumer on the plan is 23 months. We have a little over a thirty percent completion rate [for their program]." This data is clear evidence of Cambridge's understanding that although they were charging a financially-strapped consumer in advance for 60 months of service, the likelihood that the consumer would actually require Cambridge's services for the full term of their plan was less than one-third. The fact that two-thirds of their client base failed to finish the plan, cutting short any services obligated by Cambridge, was not evident in their fee structure.

Still another problem identified by the Subcommittee involves the bonuses paid to CCA employees. The "credit counselors" in the Cambridge-Brighton CCAs were given bonuses for enrolling consumers on DMPs and could accumulate bonus money equal to as much as 25% of their clients' aggregate start-up fees for the month.[149] Additionally, counselors could earn 2-week trips to Florida and other prizes by placing consumers on DMPs.[150] At the same time, like the counselors at other new CCAs, Cambridge-Brighton "credit counselors" appeared to provide minimal credit counseling. Mr. Schuck told the Subcommittee that he was on the phone with his "counselor" for a mere 20 minutes before he was convinced to mail a cashier's check for $1,946 to set up his DMP. When asked by Chairman Coleman at the Subcommittee's hearing about how many people received face-to-face counseling, Mr. Viale responded, "Approximately 10 to 20 a day." Unfortunately, most Cambridge clients do not receive face-to-face counseling. They receive, as Mr. Schuck did, a sales pitch over the telephone.

John Pohlman, a former Cambridge credit counselor, testified at the Subcommittee's hearing about his experiences at Cambridge. Mr. Pohlman offered a unique perspective having worked for a NFCC agency for 11 years before going to work for Cambridge.[151] Mr. Pohlman described a "boiler-room" mentality at Cambridge. He testified that on his first day he was forced to pick a fake name to use when dealing with consumers. He also testified, "There was an electronic board at the front of the room that reminded me of the leader's board in a golf tournament. It had the names of the counselors who had the top sales for the month flashing in red and yellow lights." Incentives like this, the bonuses, and the free trips and other gifts exhibit an obvious emphasis on the DMP. Con-

[148] NFCC 2002 Member Activity Report, p. 30.
[149] Subcommittee interview of former Cambridge employee (2/2/04).
[150] *Id.*
[151] *Id.* John Pohlman worked at the Consumer Credit Counseling Services of Southern New England prior to working at Cambridge.

sumers unfit for a DMP could fall prey to counselors with self-serving motives who fail the consumer in need of education or counseling, or perhaps, as in Mr. Schuck's case, an attorney to file bankruptcy.

Mr. Pohlman also testified about his dissatisfaction with the level of scrutiny Cambridge gave consumers' financial circumstances. Through his experience working at NFCC agencies, Mr. Pohlman believed a worthwhile counseling session should last an hour to an hour and a half in order to get all necessary information. Mr. Pohlman said that at Cambridge, this process was expected to last 10 to 15 minutes. He testified, "This was all the time we needed, however, because the only information we got from the consumer was account information. There was no true budget analysis done for the consumer, just an analysis to determine whether their creditors would allow the consumer to enroll in a debt management plan." He went on to say, "I was uneasy with the fact that I did not know anything about a person's mortgage payment, health care costs, car insurance, etc. . . . I knew nothing about them except they were in debt."

Mr. Pohlman admitted that with the limited amount of time he spent with the consumer, he had little confidence that they understood that the first payment went to Cambridge and not to their creditors. Mr. Pohlman testified, "The goal was to authoritatively take them (the consumer) through the process of getting signed up on a plan as quickly as possible so they did not have time to consult a spouse or family member." Mr. Pohlman said, "I was even instructed by one member of management to quote 'Treat them like alcoholics.' In other words, they know they need help—make them get it. I truly believe that Cambridge preyed on consumers' desperation."

Mr. Schuck's and Mr. Pohlman's testimony offers a great deal of insight into Cambridge's profit-driven approach to credit counseling. Their experiences suggest that when profit motives are injected into a traditionally non-profit industry, harm to consumers may follow. When Senator Pryor asked Mr. Viale, "Why did you choose to operate under a non-profit label?" Mr. Viale responded, "Well, I don't have a specific answer for that, but I know the industry forces us to be a non-profit."

V. REGULATION AND ENFORCEMENT

The credit counseling industry is currently governed by a patchwork of professional, state and Federal standards, some of which are mandatory and others of which are voluntary. They include standards issued by credit counseling professional associations, guidelines issued by creditors, state statutes, and Federal tax and fair trade laws.

A. Industry Self-Regulation

The credit counseling industry has two major membership associations, the NFCC and the Association of Independent Consumer Credit Counseling Agencies ("AICCCA"), each of which has issued mandatory membership standards for their members.[152] The NFCC standards, adopted through the Council on Accreditation for Children and Family Services ("COA"), are the more restrictive of the two. COA is an independent third-party not-for-profit accrediting body that has reviewed or accredited more than 1,400 international social service programs.[153]

If applied throughout the industry, these professional standards could significantly address the abusive practices identified in this Report. For example, agencies seeking COA accreditation are reviewed in eight specific areas:

- **Mission and Purpose**—determines whether consumer needs and preferences guide the organization in its design and delivery of services.
- **Quality Assurance**—evaluates the effectiveness and efficiency of services provided and corrects any observed deficiencies.
- **Governance and Administration**—determines whether the organization is governed and administered according to legal requirements and sound principles of effective management and ethical practice, evaluated by neutral oversight through a diversified board.
- **Human Resources**—evaluates the organization's ability to deploy personnel and foster efficient, effective service delivery for clients.
- **Service Environment**—ensures safe, accessible, and appropriate delivery for the needs of clients, employers, and other stakeholders.
- **Financial Management**—ensures that an organization manages its fiscal affairs according to sound financial practices and applicable statutory and professional requirements.
- **Professional Practices**—determines whether services are conducted with due regard to ethical and professional requirements and protects confidential information regarding clients.
- **Service Delivery**—ensures that an organization focuses its services on identifying the needs and problems of clients.[154]

In addition, to obtain and maintain accreditation, all NFCC member agencies must adhere to a rigid set of COA standards specific to the credit counseling industry. The standards include the following:

- Agencies must have annual audits of operating and trust accounts.
- Agencies must be licensed, bonded, and insured.
- Agencies must support and provide a variety of consumer education programs.

[152] Another organization, the American Association of Debt Management Organizations ("AADMO"), is a trade association that does not maintain membership standards.
[153] NFCC information production to the Subcommittee, 9/10/04.
[154] *Id.*

- Agencies must comply with consumer disclosure requirements.
- DMPs must include a detailed review of current and prospective income, as well as present and anticipated financial obligations.
- Funds are disbursed to creditors on behalf of the clients at least twice per month.
- Clients have a variety of deposit options including electronic methods, and are offered immediate correction of improper postings.
- Each client receives counseling, including an assessment of how he/she got into trouble, and a written comprehensive financial action plan.
- Clients receive a statement, at a minimum, every quarter.[155]

All agencies must be re-accredited by COA every 4 years. Additionally, all NFCC agencies are required to abide by strict Member Quality Standards.[156]

On August 18, 2004, the NFCC announced that it had tightened its member standards to prohibit questionable practices.[157] The NFCC enhanced seven existing member quality standards and added four new member quality standards.[158] With the additions and modifications, the NFCC specifically prohibited the payment of bonuses to credit counselors, announced that public relations and marketing activities do not qualify as educational activities, and prohibited charging fees in advance of services.[159] Additionally, the NFCC required all members to complete their submission for COA certification within 9 months of their application to COA (which is half the time previously required) and to establish a formal system of addressing consumer complaints. It also specifically prohibited the practice of "pre-screening" consumers for DMPs.[160]

AICCCA maintains similar standards as part of the code of practice to which its members must adhere. For instance, AICCCA sets a maximum initial fee of $75 for setting up a DMP and a maximum $50 fee for monthly maintenance.

Several CCAs have pointed to their compliance with an industry standard named ISO 9000 as ensuring that they adhere to high standards. ISO 9000 is a generic set of quality assurance standards that are followed by many large businesses, but it is not specific to the credit counseling industry.[161] Pursuit of ISO 9000 standards may be helpful as a first step toward improving performance, because it requires careful documentation of business procedures. But ISO 9000 does not address business products or services. For instance, nothing in the ISO 9000 standard provides guidance to an

[155] *Id.*
[156] *Id.*
[157] NFCC information production to the Subcommittee.
[158] NFCC 2004 Member Quality Standards.
[159] *Id.*
[160] *Id.*
[161] *The ISO 9000 Quality Systems Handbook, Fourth Edition,* David Hoyle, Butter-Heinemann, 2001.

entity on how much it can charge, what services it should offer, or what should be done with excess funds.

Self-regulation also has limitations. First, although NFCC and AICCCA standards are mandatory for members, joining the association itself is voluntary. CCAs that wish to operate pursuant to lower business standards or no standards can simply refuse to join. Unrestrained by strict standards of practice, these CCAs may even obtain a competitive advantage over those who adhere to more ethical conduct. Second, it is unclear whether the associations have the resources and mechanisms needed to monitor and consistently enforce compliance with their standards. Weak enforcement reduces the efficacy of even strong standards.

B. Creditor Standards

A second source of credit counseling standards lies not with the CCAs themselves, but with the large creditors, such as banks and credit card operating companies, which interact with CCAs on a regular basis. Large creditors often support CCAs by providing them with a percentage of the payments made by the debtors that the CCAs counsel. Often referred to as "fair share," these payments are intended to reimburse some operating costs in exchange for the CCAs' positive work in helping debtors repay their debts. Many of the largest creditors have developed standards to determine which CCAs are eligible to receive fair share payments. If well developed and carefully enforced, the Subcommittee believes these standards could play a major role in reducing abuses and encouraging best practices within the credit counseling industry.

(1) History of the Creditor-Credit Counseling Agency Relationship

In the late 1950s, credit card issuers played a key role in developing what we refer to today as the credit counseling industry. Originally, they helped establish local offices, known as Consumer Credit Counseling Services ("CCCSs"), which offered face-to-face counseling related to an individual's finances. These counseling sessions were viewed as comparable to other social services available at the time such as substance abuse or family counseling. These CCCSs took a comprehensive approach to treating a consumer's financial instability. Through tools such as debt management plans, referrals to other social agencies (to address other problems associated with the symptoms of the financial stress), and adequate financial education and counseling, these CCCSs nursed debt-ridden consumers back to financial health.

The NFCC is the parent organization of the CCCSs and historically has worked with creditors to operate and fund these non-profit credit counseling agencies through fair share payments.[162] The purpose of these fair share payments was to provide funding for the non-profit agencies to establish educational programs, implement debt management programs, and assist with operating ex-

[162] The creditors interviewed by the Subcommittee typically viewed fair share payments as a form of voluntary contribution to a non-profit agency, rather than as payment for a contracted service. However, many creditors apparently treat these payments as ordinary business expenses rather than take charitable deductions for them on their tax returns.

penses.[163] This funding afforded CCAs the financial freedom to offer their services to customers without charge or to make payment of a modest fee voluntary. The consumers' voluntary contributions were relatively small amounts and were waived when necessary for hardship cases.

Fair share payments are typically paid by creditors on a monthly basis on the aggregate debtor payments managed by a CCA. Until the mid-to-late 1990s, this payment was typically 12–15% of the aggregated debtor payments. In recent years, the expense associated with fair share payments has increased, at times taking up 25–30% of the budgets of the collections departments at major creditors.[164] This increase has caused some creditors to reduce their fair share payments to a lower percentage. In addition, to improve the debt management plans they receive, some creditors have moved to performance-based fair share models. These models link the percentage of fair share payments each credit counseling agency receives to the success rates of the DMPs that the creditor receives from each CCA.[165]

In addition to their historic funding relationship with non-profit CCAs, major creditors have traditionally acted in an advisory role for the NFCC through membership on the NFCC's board of directors. The close ties between creditors and NFCC members, however, led to the filing of two legal actions. In 1994, a number of independent CCAs filed an antitrust suit against the NFCC, its member agencies, and the Discover Card. The plaintiffs alleged that the NFCC members and the creditors were operating to prevent new agencies from offering certain credit counseling services. The parties eventually entered into a settlement agreement which, in part, removed the creditors from the NFCC's national board of directors.[166] In 1996, the NFCC entered into an agreement with the FTC to require its members to disclose the fact that they receive fair share payments from creditors. It is noteworthy that non-NFCC members are not required to disclose this information, even though they receive the same payments.

In the mid-1990s, the rapid increase in consumer debt dramatically increased the number of potential clients. Some new CCAs began using more technologically advanced practices to implement their DMPs through innovative software. Some also launched heavily funded advertising and marketing campaigns using late night television infomercials and the Internet. Through these practices, these new entrants to the credit counseling market were able to reach hundreds of thousands of potential clients. The ability to reach and serve a national market has gradually shifted the industry from a local, community-based, client-specific operation to include nationwide, mass-marketed sales operations.

As consumer debt reached new heights during the late 1990s and early 2000s, the DMP became the method of choice recommended

[163] Historically, 60% of NFCC funding came from creditors and 40% came from charities. Subcommittee interview of NFCC representatives (1/12/04).

[164] Subcommittee interview with Citigroup representatives (3/9/04); Bank One operating expenses spreadsheet, Bates BO 253–254.

[165] 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 two measures as well as other factors.

[166] Individual NFCC members may still have representatives from the local banking community on their board of trustees.

to consumers by many of the new CCAs to resolve unsecured debt problems. These CCAs used DMPs to generate two streams of revenue, one from creditors providing them with fair share payments, and the second from consumers charged DMP start-up and monthly maintenance fees.

Even without some CCAs' aggressive advocacy of DMPs, the rapid increase in consumer debt over the last decade would likely have produced a sharp increase in the use of DMPs.[167] At the same time, as fair share payments also increased, it should not surprise anyone that creditors began to examine the nature of this growing expense. Some creditors apparently concluded that the wrong consumers were being placed on DMPs. For example, consumers who could afford to pay their debts but were looking for a break in interest rates were unnecessarily and incorrectly placed on DMPs. As a result, the creditors heightened the level of scrutiny of proposed DMPs. Some creditors also began issuing more detailed CCA and DMP standards, in effect becoming a regulator of credit counseling practices.

(2) Three Creditor Models

The Subcommittee interviewed three major creditors to gain an understanding of the industry as well as of actions taken by the creditors towards CCAs. These creditors were Bank One Delaware, N.A. ("Bank One"), MBNA America, N.A. ("MBNA"), and Citigroup, Inc. ("Citigroup"). The Subcommittee found that all three have promulgated standards for CCAs seeking fair share payments, and that all three have recently revised and tightened their standards to eliminate abusive practices.

(a) Bank One

Bank One utilizes a combination of a minimum standards model[168] and a performance-based model when deciding whether to make fair share payments to a particular CCA. Bank One told the Subcommittee that before it will even consider making fair share payments, a CCA must be equipped to make debtor payments and submit debtor proposals electronically, and it must not be involved in any pending litigation. The agency's business eligibility is then assessed, and Bank One said the CCA must meet the following minimum standards:

- The CCA must be accredited;[169]
- The counselors employed by the CCA must be certified;
- Any fees charged to consumers must meet Bank One guidelines; and
- The CCA's marketing budget and content must be approved by the CCA's board.

[167] The Subcommittee's concern is not with DMPs per se, but whether distressed consumers are inappropriately placed onto DMPs instead of receiving counseling or education to address the financial problem.

[168] A minimum standards model requires that certain minimum criteria be met before any fair share payments will be made to a credit counseling agency.

[169] Industry-accepted accreditation organizations include COA, BSI, BVQI, and ISO 9000 with an accepted "Code of Practice." NFCC and AICCCA have each developed a code of best practices for their members that set accreditation standards.

Once these criteria were met, Bank One told the Subcommittee that it would make a maximum of 9% fair share payments to the CCA. It said that a CCA which meets the business eligibility requirements received a minimum of 2%, and the CCA may receive up to an additional 7% depending upon the performance of its portfolio of DMPs.[170] Bank One explained that its performance criteria measure the average fixed payment and the default rate of the agency, both equally weighted to provide a maximum of 3.5% in additional fair share payments for each criteria. In addition, Bank One said that it measures a CCA's performance in meeting a "New Inventory Criteria" which measures whether the agency is continuing to sign up new Bank One card members or just administering existing Bank One accounts.

(b) MBNA

MBNA told the Subcommittee it also utilizes a minimum standards model coupled with a performance-based model.[171] MBNA said that it had set minimum requirements that must be met before a CCA qualifies for any fair share payments:

- The CCA must be accredited;
- The CCA must have non-profit status under Section 501(c)(3);
- The CCA may not be affiliated with any entity that is not a Section 501(c)(3) agency; [172]
- All DMP proposals and debtor payments must be transmitted electronically;
- A complete budget disclosure must be attached to all DMP proposals;
- No DMP start-up fee may exceed $75, no monthly fee may exceed $50, and there can be no fee assessed for early termination of the DMP;
- At least 90% of the CCA's consumers must have completed a full budget disclosure; and
- At least 85% of the DMP proposals submitted by the CCA must meet MBNA's criteria for establishing a DMP.

Upon meeting these criteria, MBNA said that it assesses a CCAs' DMP portfolio to measure its payment volume and portfolio vintage. MBNA explained that the older the DMP account, the larger the percentage of fair share available, starting with 2% for brand new accounts and rising to a maximum of 15% for accounts that last 36 months or more.

[170] Subcommittee interview of Bank One representatives (2/10/04). The new model was implemented in July 2003.
[171] Subcommittee interview of MBNA representatives (2/17/04). MBNA's new model was implemented in February 2004.
[172] MBNA allows outsourcing only for payment processing.

(c) Citigroup

Citigroup told the Subcommittee that it had recently introduced a fair share model new to the credit counseling industry.[173] In fact, Citigroup indicated that it had abandoned the fair share model altogether in favor of a new "Grant Program." Under this program, Citigroup said that it will pay CCAs according to Citigroup's "perception of the agency's needs and the benefits they provide to the customer and the community."[174] Citigroup explained that these payments will be made in quarterly advances of a lump sum contribution,[175] and the amount of payment will reflect Citigroup's judgment of the value that the CCA is delivering to consumers, based on a 29 question "application." The questions in the Citigroup application address many of the same issues utilized by other industry leaders to assess CCAs, including whether the CCA has non-profit status, appropriate business practices and structure, and low start-up and monthly fees. CCAs must also submit to and pass an audit by Citigroup.

Citigroup said that its new grant program took effect in 2004. Citigroup said that, since it began, approximately one-third of the agencies who previously received fair share from Citigroup did not qualify for grant funding under the eligibility criteria.[176] However, those agencies that did qualify for grant funding received a higher payment than they historically received under the former fair share model, according to Citigroup.[177]

(3) Using Fair Share Payment Standards to End Abuses

The collective impact on the credit counseling industry of the minimum and performance-based standards issued by major creditors such as Bank One, MBNA, and Citigroup could be substantial. Since many CCAs depend upon fair share revenue as a major source of income, they are obligated to comply with creditor standards. Creditors may therefore play a major role in eliminating some of the abusive practices examined in this Report. Standards setting limits on fees, for example, directly attack the problem of CCAs' charging excessive fees unrelated to costs. Standards restricting or prohibiting CCAs from affiliating themselves with for-profit entities addresses the core of the profiteering problem. Some of the performance-based requirements also encourage CCAs to initiate only DMPs that set realistic goals for consumers.

As with the professional standards set by credit counseling associations, the effectiveness of the creditor standards will depend in large part upon the extent to which the creditors monitor compliance and discontinue fair share payments to CCAs that do not comply with their standards. Creditors informed the Subcommittee that they felt limited in their ability to police the industry, and some expressed reluctance to condition the concessions they provide to a debtor upon the debtor's choice of a particular CCA. Some creditors also worry about appearing to favor some agencies over

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[173] Subcommittee interview with representatives of Citigroup (2/20/04). Citigroup's new model was implemented on January 1, 2004.
[174] Citigroup model letter to CCA, dated November 4, 2003, Bates CC 00073–74.
[175] *Id.*
[176] Information provided by Citigroup 8/24/04.
[177] *Id.*

others, although choosing to do business with some entities and not others is a routine business decision encountered every day in the marketplace.

CCAs are less sanguine about the creditor standards. A common CCA complaint is the absence of uniformity among creditor standards that can translate into higher costs and administrative burdens for agencies.[178] Creditors respond that, while uniformity in criteria for fair share payments may be desirable, current antitrust laws prohibit creditors from collectively agreeing on common standards. Another common CCA complaint is that creditors retain the right to change their criteria without notice and may apply changes retroactively. CCAs also contend that sudden changes to creditor criteria leave them with little time to respond. This complaint applies not only to the amount of fair share payments the creditor will pay, but also to the terms a creditor will offer debtors under a DMP.

CCAs also assert that the ambiguous tone of some fair share policies and an inability to obtain creditor clarification complicates the job of administering DMPs. For example, Citigroup announced its new "grant" program on November 4, 2003.[179] Some CCAs complained that the criteria for determining fair share payments under this program are subjective, leaving agencies unsure of how to operate in order to maximize their Citigroup fair share payments. Citigroup also required CCAs to respond by November 24, 2003, only 20 days after receiving notice of the change in policy, [180] which some CCAs complained left them with little understanding of what to expect from Citigroup and an inability to plan their operating budgets.[181]

These developments suggest that bad actors have had a disproportionate impact on the credit counseling industry. As the Report has detailed, some new entrants have heavily marketed DMPs and failed to properly scrutinize the consumers placed on DMPs. In turn, creditors were forced to react to the increased volume of DMPs for which they were paying fair share. After finding inappropriate consumers placed on DMPs, many creditors reduced their fair share. Although an appropriate reaction to the activities of some new entrants, it is an unfortunate result for the CCAs that have traditionally provided quality services with careful selection of candidates for DMPs. Subcommittee Chairman Coleman questioned James Kroening, the director of an NFCC agency, Family Means, about this phenomenon at the Subcommittee's hearing. Mr. Kroening testified, "It is my belief that we have seen a major decrease in creditor support for our type of counseling and debt management work that we do related specifically to the number of new entrants and the number of folks that they are putting on plans. Specifically, I believe it is related to the fact that many people are being put into debt management plans that simply do not need it and creditors have seen their line item expense go [through] the

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[178] Subcommittee interviews with NFCC and AICCCA representatives (10/16/03, 10/9/03).

[179] Citigroup model letter to CCA, dated 11/4/03, Bates CC 00073–74.

[180] *Id.*

[181] A CCA may request a quarterly payment in advance; however, the weight Citigroup affords any such request is unknown, since Citigroup pays CCAs according to a perception of their needs and the benefits provided to customers and the community. Subcommittee interview of Citigroup representatives (2/20/04).

roof." This is another negative side effect of the new entrants profit-driven practices.

Ultimately, CCAs concede that creditors have no obligation to make any fair share payments to them. Many smaller creditors, in fact, do not typically provide fair share payments to CCAs. Thus, they recognize that creditors have the right to condition these payments as they see fit. Since having debtors pay their debts is in the best interests of the creditors, and many CCAs provide worthwhile counseling and debt management services that assist debtors in meeting their financial responsibilities, major creditors indicate they are likely to continue making fair share payments. Thus, creditor standards related to fair share payments continue to provide a valuable mechanism for curbing abusive practices in the credit counseling industry.

C. State Regulation and Enforcement

Although many states have statutes concerning the credit counseling industry, effective regulation at the state level is hampered due to the wide variety of differing state requirements and inadequate resources for monitoring compliance. In addition, many states still lack legislation directly applicable to the credit counseling industry. In these states, general laws against false advertising and fraud provide the only protection for consumers. In other states with laws that at least partially relate to credit counseling, the statutes were written when the industry generated few complaints, and therefore, either limit credit counseling to non-profit agencies or provide non-profits with an exemption from mandatory requirements. This type of exemption is the primary reason why many of the CCAs discussed in this Report applied for Section 501(c)(3) status. In recent years, a few states, such as Maryland, have passed more comprehensive laws dealing specifically with the debt management industry.

The widespread use of the telephone and Internet by CCAs to contact and service consumers also inhibits effective state enforcement. Many CCAs assert that they do not need to be licensed in a state unless they maintain a physical presence in that state. Under this interpretation, a company located in Maryland could contact and serve consumers in every other state without obtaining separate state licenses or being bound by laws of the states in which its consumers reside. Those CCAs that attempt to comply with the laws of each state in which they serve consumers are burdened by a mix of different regulations and bonding requirements.

Currently two alternatives offering model legislation for states to adopt are available. In February 2004, the National Consumer Law Center and the Consumer Federation of America jointly issued a Model Consumer Debt Management Services Act.[182] In March 2004, the National Conference of Commissioners on Uniform State Laws discussed a draft of the Consumer Debt Counseling Act.[183] Both laws would impose much tighter licensing and business practices on all credit counseling agencies.

[182] Available at *www.law.upenn.edu/bll/ulc/UCDC/Feb2004modelbill.pdf.*
[183] Available at *www.law.upenn.edu/bll/ulc/UCDC/Mar2004mtgdraft.htm.*

In many states, the most significant regulatory action has come from suits filed by state attorneys general. In addition to an earlier action brought by the District of Columbia,[184] the attorneys general in Illinois,[185] Minnesota,[186] Missouri,[187] and Texas[188] have each filed lawsuits against AmeriDebt over the past few years. These suits have typically charged AmeriDebt with consumer fraud and deceptive business practices such as false advertising, misrepresentation, non-disclosure of fees, and failure to obtain the proper licenses. The Subcommittee believes that these suits have convinced AmeriDebt to stop enrolling new consumers into DMPs. Nevertheless, they do not necessarily prevent the same business model from being used by other CCAs or conglomerates.

D. Federal Regulation and Enforcement

On the Federal level, two key agencies, the U.S. Internal Revenue Service and the Federal Trade Commission, are aware of the major problems in the credit counseling industry, and have taken steps to enforce the tax code and the Federal Trade Commission Act, respectively.

(1) The Internal Revenue Service

As the Report notes, CCAs typically apply for non-profit status under Section 501(c)(3) of the Internal Revenue Code. The IRS has recognized more than 850 credit counseling organizations as tax exempt under Section 501(c)(3).[189] The non-profit status of CCAs arose mainly by historical pattern, rather than pursuant to any specific decision by Congress. When creditors established the first CCAs, they set them up as non-profits, presumably because of the tax savings and because this status harmonized with their original purpose of providing debtors with general financial education in exchange for little or no fee. State laws often made non-profit status a legal requirement to conduct debt proration activities within their borders.

As the recent problems in the credit counseling industry began to surface, the IRS has taken several steps to address the problems both retroactively and prospectively. Retroactively, the IRS has initiated audits of 50 CCAs, including nine of the fifteen largest CCAs in terms of gross receipts.[190] The IRS Commissioner informed the Subcommittee that the Service will not hesitate to revoke the Section 501(c)(3) designation of any CCA that has abused its non-profit status.[191] The process for revoking non-profit status is fairly lengthy. The IRS must conduct a full audit of the agency's finances and make a formal finding that it does not qualify as a Section 501(c)(3) organization under the statute. The non-profit can appeal

[184] *District of Columbia v. AmeriDebt, Inc. and Andris Pukke,* Superior Court of the District of Columbia.
[185] *State of Illinois v. AmeriDebt, Inc.,* Circuit Court of the Seventh Judicial Circuit, Sangamon County.
[186] *State of Minnesota v. AmeriDebt, Inc.,* District Court, Fourth Judicial District.
[187] *State of Missouri v. AmeriDebt, Inc.,* Circuit Court of St. Louis City.
[188] *State of Texas v. AmeriDebt, Inc., et al.,* District Court of Travis County, Texas.
[189] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (11/20/03).
[190] Everson letter, p. 1. Section 6103 of the Internal Revenue Code prevents the IRS from publicly revealing the identities of the CCAs currently under audit.
[191] *Id.* at p. 7.

this decision both within the IRS and in the courts. In addition, the IRS is considering giving more explicit guidance on what the law requires of non-profits, which would put CCAs on formal notice of the standards they should follow.

Prospectively, the IRS has taken measures to subject new CCA applications for Section 501(c)(3) status to greater scrutiny. It has formed a specialized group within the IRS called the Consumer Credit Service Compliance Team to develop and pursue strategies to address: (1) inurement and private benefit issues, and (2) issues related to CCAs that operate as commercial businesses.[192] The Compliance Team currently has 12 staff members, including technical specialists, examination agents, and attorneys from the Office of Chief Counsel.[193] These individuals review the applications, including budgets and outsourcing contracts, of new CCAs to ensure that they plan to operate as bona fide non-profits.

Since the Subcommittee's hearing on March 24, 2004, the IRS has identified 59 CCAs for examination.[194] It has contacted 39 of the selected CCAs and has begun examinations.[195] It has already proposed revoking the tax-exempt status of one Section 501(c)(3) credit counseling agency.[196] In June 2004, it filed a $15 million suit against AmeriDebt in anticipation of revoking its Section 501(c)(3) status.[197] The IRS has also sent denial letters to four applicants for exempt status because the organizations were operating for the substantially non-exempt purpose of marketing and selling debt management plans for the private benefit of insiders and related commercial entities.[198]

As a result of these efforts, the IRS will have about 50% of the total revenues of the credit counseling industry under examination.[199] For those CCAs under examination, the IRS has identified individuals and businesses that are involved in a scheme to create CCAs as a front for related for-profit businesses.[200] Referrals have been made to investigate these abusive tax shelter promotions. The referrals include the promoter, all related entities and individuals, as well as the attorney and the CPA.[201]

To combat such violations, the IRS has announced revisions of its Form 990, Return of Organization Exempt from Income Tax, and the Form 1023, Application for Tax Exempt Status Under Section 501(c)(3).[202]

On July 30, 2004, the IRS also released a memorandum of legal analysis related to the revocation of Section 501(c)(3) status for credit counseling organizations.[203] This can be viewed as a sign of the IRS bracing for litigation ahead as it implements its more

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[192] *Id.* at p. 4.
[193] *Id.*
[194] Internal Revenue Service information production to the Subcommittee 9/1/04.
[195] *Id.*
[196] Everson letter to the Honorable Amo Houghton, dated 7/15/04, p. 1.
[197] Proof of Claim for Internal Revenue Taxes, In the Matter of AmeriDebt, Case No. 04–23649, filed 6/5/04.
[198] Everson letter to the Honorable Amo Houghton, dated 7/15/04, p. 1.
[199] *Id.*at p. 3.
[200] Internal Revenue Service information production to the Subcommittee 9/1/04.
[201] Everson letter to the Honorable Amo Houghton, dated 7/15/04, p. 3.
[202] *Id.*
[203] Office of the Chief Counsel, Memorandum No. 200431023.

stringent practices, most likely leading to the revocation and denial of exempt status for existing organizations.

(2) The Federal Trade Commission

The FTC is charged with enforcing Section 5(a) of the FTC Act, which prohibits unfair and deceptive acts or practices affecting interstate commerce.[204] The FTC lacks jurisdiction, however, to enforce consumer protection laws against bona fide non-profits. Nevertheless, the FTC may assert jurisdiction over a CCA if it demonstrates that the CCA is "organized to carry on business for its own profit or that of its members."[205] Alternatively, the FTC may assert jurisdiction over a non-profit CCA if it is a "mere instrumentality" of a for-profit entity, or if it operates through a "common enterprise" with one or more for-profit entities.[206] Even with these jurisdictional issues to contend with, the FTC has made inroads in enforcing the FTC Act against CCAs who may be abusing their non-profit status and engaging in unfair or deceptive practices.

At the Subcommittee's hearing, FTC Commissioner Thomas Leary testified to a number of practices that have come to the agency's attention that may violate the FTC Act. For example, Commissioner Leary listed the following as concerns with some existing CCAs:

- Misrepresentations about fees or "voluntary contributions."
- Promising great savings they often cannot deliver.
- Abuse of non-profit status.
- Failure to pay creditors in a timely manner or at all.
- Failure to abide by telemarketing laws.
- Noncompliance with the privacy and security requirements of the Gramm-Leach-Bliley Act, which restrains unauthorized use of personal financial information.[207]

On November 19, 2003, the FTC filed a complaint in Federal court against AmeriDebt, DebtWorks, Andris Pukke, and Pamela Pukke, and a second complaint against The Ballenger Group alleging these types of unfair and deceptive practices.[208] The first complaint seeks to enjoin AmeriDebt, DebtWorks, and Mr. Pukke from making false and deceptive claims about the nature and costs of the services provided by AmeriDebt. That suit is ongoing. The FTC has settled the second case against Ballenger, which agreed to pay a $750,000 fine and change its practices, as described later in this Report.

In addition to its joint efforts with the IRS to inform consumers of the deceptive practices of some CCAs, at the hearing, the Honorable Commissioner Thomas Leary told the Subcommittee: "the Commission is also currently conducting several non-public inves-

[204] 15 U.S.C. § 45(a).
[205] 15 U.S.C. § 44.
[206] *See Sunshine Art Studios, Inc. v. FTC,* 481 F.2d 1171 (1st Cir. 1973); *Delaware Watch Co. v. FTC,* 332 F.2d 745 (2d Cir. 1964).
[207] Testimony of Commissioner Thomas Leary at Subcommittee hearing, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* March 24, 2004.
[208] *FTC v. AmeriDebt, Inc., et al.,* Case No. PJM 03cv3317, United States District Court for the District of Maryland; *FTC v. The Ballenger Group, LLC, et al.,* United States District Court for the District of Maryland.

tigations of additional CCAs, debt negotiators, and related entities." Most likely, such investigations will result in the FTC taking additional action against existing CCAs and their for-profit affiliates.

(3) Pending Bankruptcy Legislation

Another factor affecting Federal oversight of the credit counseling industry is the possibility that Congress may enact bankruptcy reform legislation requiring greater use of credit counseling. In the 108th Congress, for example, Section 106 of H.R. 975 would have amended Federal bankruptcy law to require that all consumers receive "an individual or group briefing . . . that outlined the opportunities for available credit counseling and assisted that individual in performing a related budget analysis." The briefing would have to come from an approved non-profit budget and credit counseling agency within 180 days prior to filing a petition for bankruptcy. The bill would have also required debtors to complete "an instructional course concerning personal financial management" after filing for bankruptcy under either Chapter 7 or Chapter 13.

Moreover, the bill would have required the clerk of each bankruptcy district to maintain a public list of CCAs and instructional courses approved by the United States Bankruptcy Trustee or the bankruptcy administrator in the district. CCAs and instructional courses would have had to meet the following criteria:

- Provide qualified counselors;
- Maintain adequate provision for the safekeeping and payment of client funds;
- Provide adequate counseling with respect to client credit problems; and
- Deal responsibly and effectively with other matters as they relate to the quality, effectiveness, and financial security of counseling programs.

Although the bill leaves these requirements to the Bankruptcy Trustee or the bankruptcy administrator for the individual districts to define, it does spell out certain minimum criteria. To be approved, a credit counseling agency must, among other requirements:

- Be a non-profit agency;
- Have a board of directors, the majority of which are not employed by the agency, and will not directly or indirectly benefit financially from the outcome of a credit counseling session;
- Charge a "reasonable" fee and provide services without regard to the debtor's ability to pay the fee;
- Provide full disclosure to clients regarding funding sources, counselor qualifications, possible impact on credit reports, any costs that will be paid for by the debtor, and how such costs will be paid;

- Provide adequate counseling that includes an analysis of the debtor's current situation, what brought them to that financial status, and how they can develop a plan to handle the problem without incurring negative amortization of their debts; and
- Provide trained counselors who receive no commissions or bonuses based on the counseling session outcome and who have adequate experience and training.

The bill also spelled out minimum requirements for instructional courses on personal financial management. These courses, among other requirements, would have had to:

- Provide experienced and trained personnel;
- Provide relevant learning materials and teaching methodologies;
- Provide adequate facilities: instruction may occur over the telephone or the Internet if it is effective; and
- Demonstrate after the probationary period that it has been or is likely to be effective in assisting "a substantial number of debtors" to understand personal financial management.

The bill would have allowed CCAs and courses to be approved for a 6-month probationary period and for 1-year terms thereafter. The bill also would have allowed "interested parties" to seek judicial review of these approvals. The bill also would have allowed a district court to investigate any credit counseling agency and remove it from the list.

VI. POST HEARING CHANGES IN THE INDUSTRY

Since the Subcommittee's hearing in March of 2004, a number of reforms have taken place throughout the credit counseling industry that may benefit consumers. Most notably, the three credit counseling agencies chronicled in this Report have undergone drastic changes ranging from bankruptcy to complete reorganization. The Internal Revenue Service has tightened its application process for Section 501(c)(3) status and heightened their scrutiny of current CCAs with tax-exempt status. Trade associations have tightened their member standards and educated their members on the current scrutiny and the need to comply with the requirements of Section 501(c)(3). Creditors have similarly tightened their standards for making fair share payments. The industry has a long way to go; however, with each improvement, consumers are one step closer to a service they can rely on.

A. DebtWorks and The Ballenger Group

Ballenger performed DMP processing for 11 non-profit CCAs, including AmeriDebt. Representatives of DebtWorks, Ballenger, and AmeriDebt were invited to testify at the Subcommittee's hearing. Matthew Case, chief operating officer of AmeriDebt, testified on behalf of AmeriDebt. Andris Pukke who was subpoenaed to appear on behalf of DebtWorks, invoked his Fifth Amendment privilege to remain silent. Michael Malesardi, the chief financial officer for Ballenger, testified in his place on behalf of Ballenger.

At the time of the hearing, the FTC had filed complaints against AmeriDebt, DebtWorks, Andris Pukke, Pamela Pukke, and Ballenger.[209] Currently, AmeriDebt's action is still pending, while Ballenger settled with the FTC on November 19, 2003, agreeing to pay a $750,000 fine and change its business practices.

(1) AmeriDebt Files for Chapter 11 Reorganization

On June 5, 2004, AmeriDebt filed a petition for relief under the Chapter 11 reorganization provision of the Bankruptcy Code.[210] Eight months earlier, AmeriDebt had stopped enrolling clients on DMPs.[211] However, Federal and state enforcement actions have not been stayed by AmeriDebt's bankruptcy petition.[212] On June 24, 2004, the U.S. Bankruptcy Court in Maryland directed the United States Trustee to appoint an Examiner for AmeriDebt in order to determine if a trustee should be appointed to manage AmeriDebt operations.[213] The court ordered the Examiner to assess AmeriDebt's financial status, assess AmeriDebt's connection or relationship with Ballenger (including the officers, directors, and employees), and perform a preliminary preferences analysis.[214] On August 11, 2004 Raymond Peroutka, Jr. was appointed as the Bankruptcy Examiner in the matter.

AmeriDebt currently manages 57,000 DMPs all serviced by Ballenger.[215] The remaining nine employees at AmeriDebt provide "credit counseling" to AmeriDebt's existing clientele via the telephone. The service processing provided by Ballenger makes up AmeriDebt's largest monthly expense. In the first 7 months of 2004, AmeriDebt earned a net profit of approximately $1.5 million.[216] Despite earning a net profit each month excluding May, the AmeriDebt management informed the Examiner's staff they do not anticipate reorganizing and emerging from Chapter 11.[217]

In assessing AmeriDebt's finances, the Examiner took issue with the transfer of AmeriDebt's servicing rights to DebtWorks in 1999. The Examiner pointed out that AmeriDebt transferred to DebtWorks, for virtually no consideration, servicing rights that would generate $107 million in fees over the next 4½ years.[218] Using the January 2003 sale of 51% interest in the company owning the servicing rights and the profitability of the current owner of the servicing rights, Ballenger, the Examiner deduced that had this transfer been properly priced, AmeriDebt would have earned net profits for 2003 of $9.1 million.[219] Even with such profitability, the Examiner noted the pending state and Federal suits against AmeriDebt seeking restitution as a concern. Most important of these suits is

[209] *FTC v. AmeriDebt, Inc., et al.,* Case No. PJM 03cv3317, United States District Court for the District of Maryland; *FTC v. The Ballenger Group, LLC, et al.,* United States District Court for the District of Maryland.

[210] AmeriDebt letter to the Subcommittee, dated 8/23/04. *In Re: AmeriDebt Inc.,* Case No. 04–23649–PM, In the District Court of Maryland, Greenbelt Division.

[211] AmeriDebt letter to the Subcommittee, dated 8/23/04.

[212] *Id.* at p. 2.

[213] Report for Examination, Case No. 24–23649-PM, United States Bankruptcy Court, District of Maryland, Greenbelt Division, p. 1.

[214] *Id.*

[215] *Id.* at p. 3.

[216] *Id.*

[217] *Id.*

[218] *Id.* at p. 7.

[219] *Id.*

an IRS claim for $15 million in anticipation of a finding that AmeriDebt violated its Section 501(c)(3) status. Ultimately, the Examiner recommended appointing a trustee and on September 20, 2004 the court approved Mark D. Taylor as trustee.[220]

On January 23, 2005 the Federal bankruptcy judge approved the sale of roughly 60,000 remaining accounts to Money Management International, a large Houston CCA. This sale paves the way for the eventual dissolution of AmeriDebt as a company. The judge had earlier determined that, given the number of suits pending against AmeriDebt, dissolution was the best option.

(2) The Ballenger Group

Since the Subcommittee's hearing and the settlement of the FTC lawsuit, Ballenger has made a number of reforms to conform to the laws governing tax-exempt organizations and is also working as an advocate of for-profit CCAs. Among its reforms, Ballenger has modified its Fulfillment Agreement, changed its fee structure, and renegotiated its debt to Andris Pukke.

Of the 11 CCAs that the Report described Ballenger as previously serving, only five currently have agreements with Ballenger for future DMP processing. Ballenger has executed Fulfillment Agreements with Debtscape, Debtserve, Fairstream, The Credit Network, and Visual Credit Counseling. According to Ballenger, it has made the following modifications to its Fulfillment Agreement with these CCAs: [221]

(1) The agreement between Ballenger and each CCA is now an "at will" contract. Either party may terminate the agreement at any time for any reason.[222]

(2) Ballenger has eliminated the right to transfer consumers' DMPs from one CCA to another Ballenger CCA for any reason.

(3) The rights to exclusive access to the CCAs' consumer trust accounts (consumers' monies designated for payment to creditors) have been eliminated. However, Ballenger maintains the right to access CCA escrow accounts in the event of non-payment.

(4) An automatic fee increase of 3% annually was eliminated.

(5) Ballenger's right to market CCAs' consumers for goods and services in exchange for a revenue sharing agreement with the CCA has been eliminated.

(6) All non-competition and exclusivity clauses requiring the CCA to do business only with Ballenger have been removed.

(7) A clause requiring each agency to comply with all rules and regulations issued by the IRS has been added. In particular, Ballenger requires each CCA to certify that all nec-

[220] *Order Approving Appointment of Trustee,* Case No. 24–23649 PM, United States Bankruptcy Court, District of Maryland, Greenbelt Division, 9/20/04.

[221] Subcommittee interview with Ballenger representatives (9/29/04).

[222] The "at will" contract comes with two requirements: (1) from date of notice, Ballenger will process the CCA's DMPs for 90 days and (2) the CCA must have a zero balance for their receivables with Ballenger or a "mutually agreeable plan" for resolving them.

essary steps have been taken to comply with section 4958 which guards against excess benefit to a third party.[223]

Ballenger has also reduced its fees to each CCA from $25/$30 per DMP per month (depending on electronic submission) to $16/$19 per DMP. Ballenger has reduced the monthly fee by 10% on pre-2003 DMPs. Such reductions make Ballenger's fees competitive with the lowest in the industry.[224]

As the Report detailed, on October 2003 Andris Pukke sold the rights to service various CCAs to Ballenger for $43 million with an outstanding note to Pukke for $37 million. Ballenger has renegotiated this debt, settling with Andris Pukke for $500,000 plus another payment to Pukke of $250,000 for an agreement not to compete with Ballenger.

At the same time it has reformed its practices, The Ballenger Group has recently started and funded a new group called the Coalition for Responsible Credit Solutions ("CRCS"). CRCS aggressively advocates the for-profit CCA model and has launched a well-funded campaign to influence the pending language of a state model law regulating the credit counseling industry to allow for-profit CCAs. The CRCS criticizes the creditors and the NFCC and its CCAs, asserting that a CCA that accepts money from a creditor is working only for the creditor's interests.

The CRCS's website includes a checklist for consumers on how to pick a CCA.[225] This list suggests that face-to-face counseling is unnecessary and that a consumer should be able to get all needed education and counseling from the Internet. Additionally, CRCS suggests the IRS may revoke CCAs' tax-exempt status for accepting fair share payments from creditors, leaving few financial options for debtors and causing "a bankruptcy explosion."[226]

For-profit CCA advocates have apparently convinced the National Conference of Commissioners on Uniform State Laws ("NCCUSL") to incorporate a place for for-profit CCAs in their model law. As mentioned, the Consumer Federation of America and the National Consumer Law Center have also prepared a model law, which allows for-profit CCAs. However, in a letter to NCCUSL, the groups expressed reservations about the for-profit model's ability to survive with the imposed fee limits they are suggesting.[227] The CFA and NCLC maintain that they are neutral on the issue and have neither "endorsed" nor rejected the for-profit model.[228] They also state: "We note with concern that some of the credit counseling entities that have been most aggressive in insisting that creditors and legislators endorse the for-profit model, like The Ballenger Group, are the very same companies who have been investigated, sued or sanctioned for deceptive acts by state and Federal regulators or lawmakers." They go on to say, "In our opin-

[223] Ballenger Fulfillment Agreement with The Credit Network executed September 1, 2004 ¶ 2.10.

[224] Fair Market Value Evaluation prepared for The Ballenger Group, April–June 2004.

[225] Available at *www.responsiblecredit.com/index.php. See also,* "New Debt Counseling Group Draws Fire; Doubts: A Consumer Advocacy Group is Accused of Being a Creature of the Growing Debt Counseling Industry," *The Baltimore Sun,* July 21, 2004.

[226] "Consumers for Responsible Credit Solutions Warns of a Future Bankruptcy Explosion if Most States or Congress Don't Act to Change Current Credit Counseling Laws," *PR Newswire,* August 26, 2004.

[227] NCLC/CFA letter to Commissioner William C. Hiloman, dated 8/3/04.

[228] *Id.* at p. 5.

ion, this means that their claims that the for-profit model would be the salvation of the credit counseling industry completely lack credibility."[229] The CFA and NCLC support a non-profit presence as vital to the credit counseling industry and its future.[230]

B. The Ascend One-Amerix Conglomerate

As the Subcommittee's investigation proceeded, both AFS and Amerix notified the Subcommittee that each intended to modify its business practices. At the hearing, Cuba Craig, president and CEO of AFS, described the reforms that AFS had undertaken to conform to the letter and spirit of the law. It should be noted that AFS did not charge up front fees and had capped its monthly fees at $50 per month even prior to the Subcommittee's investigation. Criticisms of AFS operations were confined to its outsourcing and service agreement with Amerix. Cuba Craig testified, "Since the Subcommittee began its investigation, we have stepped up our efforts to ensure that AFS meets all applicable requirements."

To that end, AFS told the Subcommittee that it had implemented the following changes to its operations:

(1) Origination, counseling, and all DMP enrollment are now done in- house.[231]

(2) The service agreement requirements to enroll 30% of all first time callers on DMPs (the "assist rate") and to generate $30 revenue per month in consumer fees for each DMP (the "revenue standard") were eliminated in April 2004. [232]

(3) AFS terminated both the FreedomPoint Strategic Marketing Agreement and the the FreedomPoint Mortgage Brokerage Prospect Lead Agreement on May 1, 2004, which meant that AFS was no longer required to make client referrals to these for-profit companies.[233]

(4) On May 5, 2004 AFS gave notice to Amerix that it would not renew the Amerix Benefits Package Marketing Agreement at the end of its initial term, and that AFS wished to cease marketing the Member Benefits Package. AFS was released from its marketing obligations in mid-August.[234]

(5) AFS solicited information about competitive bids for marketing services and conducted an analysis of the back office servicing in order to assess the fair market prices of such services. AFS issued a request for proposal for back office services in mid-September.[235]

[229] *Id.*
[230] *Id.*
[231] Second Addendum to Service Agreement between Amerix and American Financial Solutions, dated 4/12/04.
[232] *Id.*
[233] AFS letter to the Subcommittee, dated 8/31/04.
[234] Letter from AFS to Amerix, dated 5/5/04.
[235] *Id.*

(6) AFS scripts regarding voluntary contributions have been revised to ensure that consumers are clear that any contribution is voluntary.[236]

(7) The AFS website has been changed to provide educational resources to all visitors, not just AFS clients.[237]

(8) In August 2004, AFS opened a community learning center in the poorest neighborhood school in the Bremerton School District, near an AFS call center in Washington state. The Learning Center offers classes, tutoring, counseling and other financial and credit education to anyone who wishes to participate, free of charge.[238] In addition, AFS has created an internship where the students work with the AFS Education Manager conducting surveys of the community to identify financial education needs.[239]

(9) In an effort to ensure that appropriate consumers are on DMPs, AFS has assigned three counselors to follow up with consumers who miss payments to determine whether the consumers should remain on the DMP and provide additional counseling if needed.[240]

Amerix, which provides debt servicing to CCAs in the conglomerate, has also made a number of significant changes in its operations. Bernaldo Dancel, president and CEO of Ascend One, the holding company of Amerix, said at the hearing, "We recognize that we can always do better, and this investigation has played quite a constructive role for our company in helping us." Mr. Dancel noted, "I think, frankly, the area where I believe there is particular room for improvement is in seeing the CCAs we serve offer good education and counseling to all consumers seeking assistance, whether they are suitable for a DMP or not." Amerix told the Subcommittee that its reforms include the following:

(1) Amerix has enlisted "Enhanced Standards" that will be required of every non-profit CCA wishing to do business with Amerix. Amerix told the Subcommittee that these enhanced standards include all of the requirements of AICCCA or NFCC membership, and require CCAs to conduct community outreach of 1,000 hours per year, perform individual client assessments regardless of whether clients choose to enroll in a DMP, prepare budgeting worksheets with tips for the client, and partner with an educational institution to increase educational offerings and consumer financial awareness.[241]

(2) Amerix ceased providing overflow origination services to American Financial Solutions on March 15, 2004 and determined not to provide such services to any other CCA.[242]

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[236] AFS letter to the Subcommittee, dated 8/31/04.
[237] *Id.*
[238] AFS received partial funding for the learning center from the Association of Independent Consumer Credit Counseling Agencies. 2004 AICCCA Consumer Education Grant 7/13/04.
[239] AFS letter to the Subcommittee, dated 8/31/04.
[240] *Id.*
[241] Ascend One letter to the Subcommittee, dated 8/23/04.
[242] Second Addendum to Service Agreement between Amerix and American Financial Solutions, dated 4/12/04.

(3) Amerix eliminated any assist rate or revenue standard from its service agreement with its CCAs so there are no minimum DMP enrollment or monthly fee generation, as explained earlier with respect to AFS.[243]

(4) Amerix worked with its CCAs to review and modify all scripts used by counselors when assisting clients with credit counseling.[244]

(5) Ascend One has provided funding of $500,000 and pledged over $5 million over 10 years to the Ascend One fund for financial literacy. In addition, on July 21, 2004, Ascend One made a $24,000 grant to Junior Achievement to provide financial literacy education in the Baltimore City Schools, and another grant on July 28, 2004, of $50,000 over a 5-year period to the Maryland Council on Economic Education.[245]

(6) Amerix also agreed to negotiate in good faith the fee structure for the services Amerix provides for AFS to reflect actual costs and the value of services provided.[246]

C. The Cambridge-Brighton Conglomerate

Cambridge representatives were invited to testify at the Subcommittee's hearing on March 24, 2004. Mr. Viale was invited to represent Cambridge, the non-profit CCA. Mr. Puccio was invited to represent the back office service provider for Cambridge and Brighton Debt Management. On the eve of the hearing Mr. Puccio informed the Subcommittee of health concerns that would prevent him from testifying. Mr. Viale attended the hearing and provided testimony on the CCA part of Cambridge's operations. A deposition of Mr. Puccio took place on July 1, 2004 and is included in the hearing record.[247]

Since the Subcommittee hearing on March 24, 2004, Cambridge has taken steps to overhaul its entire corporate structure. Discussed below are changes that the Cambridge-Brighton conglomerate told the Subcommittee it was making to transition from a profit-driven group of companies to a system of operations driven by non-profit motives.

Cambridge-Brighton told the Subcommittee that a new non-profit holding company will be created called "Cambridge Credit Non-Profit Holding Company" that will function as the parent company.[248] This company will be the sole owner of each non-profit CCA and the sole shareholder of two of the for-profit companies, Cambridge Index and Brighton Credit Management Corp.[249] In addition, the for-profit service companies still wholly owned by John and Richard Puccio, Brighton DMS, Debt Relief Clearing House Ltd., and Cypress Advertising & Promotions, Inc. ("the servicing

[243] *Id.*

[244] Ascend One letter to the Subcommittee, dated 8/23/04; CESI Financial Counseling Session Guidelines and Disclosure Requirements; AFS Scripts.

[245] Ascend One letter to the Subcommittee, dated 8/23/04; Ascend One, Concentration Account, bank statement March, 2004.

[246] American Financial Solutions letter to the Subcommittee, dated 8/31/04.

[247] *Profiteering in a Non-Profit Industry: Abusive Practices in the Credit Counseling Industry,* March 24, 2004, Exhibit No. 18, p. 264.

[248] Cambridge letter to the Subcommittee, dated 8/31/04.

[249] *Id.*

companies"), will become wholly owned subsidiaries of a new for-profit holding company called "Cambridge Credit For-Profit Holding Company," whose stock will be wholly owned by the non-profit CCAs, Cambridge and Cambridge Budget Planning.[250] As a result, Cambridge-Brighton told the Subcommittee that any and all profits of the servicing companies and the for-profit Cambridge Index and Brighton Credit, the for-profit CCA, will inure to the benefit of the non-profit CCAs and the non-profit holding company.

The Subcommittee was also told that officers and employees of Cambridge will transfer the capitol stock of Brighton DMS, Debt Relief Clearing House, and Brighton Credit (the for-profit CCA) to the non-profit holding company.[251] Pursuant to these changes, the non-profit CCAs will control through the non-profit holding company, Cambridge Credit Non-Profit Holding Company, 100% of the stock of each of the servicing companies. The non-profit holding company will also own all of the stock of the servicing companies and the for-profit CCA, Brighton Credit. Consequently, all profit generated by the for-profit companies will be in the control of and available for use by the non-profit companies.

Cambridge-Brighton said that with the reorganization, the board of directors of the non-profit CCAs and the non-profit holding company will be expanded to include nine members, eight of whom will be independent directors who may not be officers, employees, or independent contractors of the non-profit CCAs or the non-profit holding company.[252] For the for-profit companies, the governing board will consist of three directors, two of whom will be independent.[253]

Cambridge-Brighton told the Subcommittee that as of June 1, 2004 all of its CCAs—Cambridge, Cambridge/Brighton Budget Planning, and Brighton Credit—had modified the fees charged to consumers for the construction and maintenance of the DMP.[254] The maximum fee charged for initiating a DMP will be $75 and the maximum monthly fee for maintenance is $50 per month.[255] Additionally, Cambridge has instituted a new refund policy allowing consumers to cancel the DMP at any time in the first 90 days of enrollment with a full refund available.[256]

Cambridge-Brighton told the Subcommittee that its CCAs have introduced a system called "post counseling" in which their counselors follow up with consumers placed on DMPs to ensure that they are utilizing the budgeting tools provided to track their finances. Three scheduled calls are supposed to be completed within the first 90 days of entering the DMP and the goal is to emphasize the need to develop savings.[257]

For the community, Cambridge told the Subcommittee that it has committed $4 million over the next 3 years for the program "Learn Now or Pay Later,"[258] working with high school students across the nation to educate them on the responsibilities that ac-

[250] *Id.*
[251] *Id.*
[252] *Id.*
[253] *Id.*
[254] *Id.*
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] *Id.*

company credit. Students achieving excellence in the program will be awarded scholarships. Additionally, Cambridge works with a local Job Corp program to educate at-risk youths about the importance of responsible financial habits.[259] Speaking engagements at local colleges and information booths at local shopping malls are also part of their community outreach.[260]

If implemented, these and other reforms should help resolve the abusive practices documented in this report.

D. Recommendations

Based upon its investigation of the credit counseling industry, the Subcommittee makes the following recommendations:

(1) **Complete Industry Cleanup.** The IRS and FTC should complete their ongoing reviews of the credit counseling industry to eliminate abusive conduct by credit counseling agencies that have been operating in violation of restrictions on non-profit charities or using unfair or deceptive trade practices.

(2) **Establish Five-Year Review.** In light of past industry abuses, the IRS should require each credit counseling agency exempt from Federal taxation under Section 503(c)(3) to submit every 5 years, for IRS review, return information establishing its charitable activities and a certification that the agency is not providing a private benefit to any individual or entity. The IRS should review these materials to ensure each credit counseling agency is operating as a charitable organization and in compliance with the law for non-profit entities. Congress should consider enacting legislation conditioning a credit counseling agency's tax exemption on the submission of this documentation and the IRS's renewal of its tax-exempt status for 5-year periods.[261]

(3) **Provide Consumer Education.** To address rising consumer debt and bankruptcy rates, each credit counseling agency should provide affirmative financial counseling and educational programs designed to reduce excessive indebtedness within the populations they serve, and should evaluate, improve, and document the effectiveness of these programs.

(4) **Continue Creditor Support and Standards.** Major creditors should continue to provide financial support to appropriate, non-profit credit counseling agencies, conditioned upon the agencies' achieving specified standards that contribute to the public good, including standards requiring agencies to maintain good standing and accreditation status within the industry, assess reasonable fees based upon actual costs, provide individualized debt coun-

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[259] *Id.*

[260] *Id.*

[261] The United States Senate Finance Committee has circulated a Discussion Draft of proposals for reforms and best practices in the area of tax-exempt organizations. The Committee suggests a five-year review of tax exempt status by the IRS, including the filing of current articles of incorporation and by-laws, conflict of interest policies, evidence of accreditation, management policies regarding best practices, a detailed narrative about the organization's practices, and financial statements.

seling to clients, and avoid conduct or transactions that generate or create the appearance of generating a private benefit for any individual or entity. Creditors should carefully screen credit counseling agencies to ensure they provide funds only to reputable agencies that comply with their standards.

(5) **Clarify Federal Standards.** The IRS and FTC should work together to clarify the standards that credit counseling agencies must meet to maintain tax exempt status under Section 501(c)(3) and avoid deceptive or unfair trade practices, including by making it clear that a non-profit credit counseling agency must:

(a) **Accreditation**—maintain good standing and accreditation status within the credit counseling industry, such as by meeting the accreditation standards of the Council on Accreditation for Children and Family Services;

(b) **Independent Board**—maintain an independent Board of Directors that includes representatives of the community served by the agency and that includes no more than a minority of directors who are employed by the agency, a related entity, or any other person who stands to gain direct or indirect financial benefit from the agency's activities;

(c) **Public, Not Private Benefit**—avoid conduct or transactions that generate or create the appearance of generating a private benefit for any individual or entity;

(d) **Full Disclosure**—disclose to each client the existence and nature of any financial relationship that the agency has with a creditor of the consumer or with a for-profit entity that provides data processing, marketing, or financial services to the agency or the client;

(e) **Reasonable Fees**—assess clients reasonable fees that are based upon the agency's actual costs and charged as services are provided, rather than substantially in advance of such services; and

(f) **No Improper Incentives**—refrain from accepting compensation for referring clients to any service or organization, and refrain from paying compensation to any employee based upon the number of clients enrolled in debt management plans or the amount of client debt managed by the agency.

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