National Association of Consumer Bankruptcy Attorneys

CONSUMER ALERT

THE DEBT SETTLEMENT TRAP: THE #1 THREAT FACING DEEPLY INDEBTED AMERICANS

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Already struggling with home foreclosures, harsh bank and credit card fees, and other major financial challenges, America's most deeply indebted consumers are now falling victim to a major new threat: so-called "debt settlement" schemes that promise to make clients "debt free" in a relatively short period of time. Unfortunately, most consumers who pursue debt settlement services find themselves facing not relief but even steeper financial losses.

Even the industry acknowledges – though not in its ever-present radio and online advertising–that debt settlement schemes fail to work for about two thirds of clients. Federal and state officials put the debt-settlement success rate even lower – at about one in 10 cases – meaning that the vast majority of unwary and uninformed consumers end up with more red ink, not the promised debt-free outcome.

There is now widespread documentation of the danger that debt settlement schemes pose to consumers. The Better Business Bureau has designated debt settlement as an "inherently problematic business."[1] Similarly, the New York City Department of Consumer Affairs called debt settlement "the single greatest consumer fraud of the year." Across the country, the U.S. Government Accountability Office (GAO),[2] the Federal Trade Commission (FTC), 41 state attorneys general,[3] consumer and legal services entities,[4] and consumer

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[1] The Better Business Bureau provided data to State attorneys general showing that since 2007, debt settlement and debt negotiation companies have annually generated the most complaints received by the Bureau. See Comments of the National Association of Attorneys General to Federal Trade Commission re Telemarketing Sales Rule - Debt Relief Amendments, Matter No. R411001 at n.5 and text (Oct. 23, 2009, available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00192.pdf.

[2] Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risk to Consumers (U.S. Gov't Accountability Office Rep. No. GAO-10-593T Apr. 22, 2010) [hereinafter U.S. GAO Report], available at http://www.gao.gov/new.items/d10593t.pdf.

[3] Comments of National Association of Attorneys General to Federal Trade Commission re Telemarketing Sales Rule – Debt Relief Amendments, Matter No. R4110011 (Oct. 23, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00192.pdf.

[4] Comments of South Brooklyn Legal Services to Federal Trade Commission re Telemarketing Sales Rule Debt Relief Amendments, Matter No. R411001 (Oct. 26, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00216.pdf; Comments of Consumer Federation of

bankruptcy attorneys have all uncovered substantial evidence of abuses by a wide range of debt settlement companies.

The debt settlement industry is regulated by state attorneys general and the FTC. Though state laws vary widely in terms of overseeing the industry and its practices, experts agree it is very risky and that consumers should proceed with extreme caution before entering into a contact with a debt settlement company.

KNOW THE HALLMARKS OF DEBT SETTLEMENT TRAPS

Debt settlement companies are for-profit entities that offer to negotiate with creditors to reduce the amounts owed by a debt-strapped consumer. They typically charge steep fees for every settlement they achieve. In some cases, they charge very high fees even without obtaining any settlements.

Here are the "red flags" that consumers need to know about when dealing with debt-settlement firms:

- ***Debt-settlement schemes encourage consumers to default on their debts***. Because creditors frequently will not negotiate reduced balances with consumers who are still current on their bills, debt settlement companies often instruct their clients to stop making monthly payments, explaining that they will negotiate a settlement with funds the client has paid in lieu of their monthly debt repayments. Once the client defaults, he or she faces fines, penalties, higher interest rates, and are subjected to increasingly aggressive debt-collection efforts including litigation and wage garnishment. Consequently, consumers often find themselves worse off than when the process of debt settlement began: They are deeper in debt, with their credit scores severely harmed.

- ***Debt settlement often makes a bad problem even worse.*** When a consumer defaults on his or her debt, the overall debt burden can rise quickly. As accumulating penalties and interest charges inflate the consumer's debt-load, creditors begin collection efforts and many eventually sue. This is why debt settlement is always a gamble: If any of the creditors refuse to settle, the consumer is left worse off than when they started.

- ***The painful bottom line is that most consumers lose the debt settlement gamble.*** In most cases, the consumer loses the gamble: The debt settlement company is unable to settle with all the consumer's creditors, so the consumer's unsettled debts rapidly

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America to Federal Trade Commission re Telemarketing Sales Rule - Debt Relief Amendments, Matter No.R411001 (Oct. 16, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00161.pdf; Comments of Consumers Union to Federal Trade Commission re Telemarketing Sales Rule - Debt Relief Amendments, Matter No. R411001 (Oct. 9, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00139.pdf; Comments of Queens Legal Services to Federal Trade Commission re Telemarketing Sales Rule - Debt Relief Amendments, Matter No. R411001 (Oct. 22, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00185.pdf; Comments of Southeastern Ohio Legal Services to Federal Trade Commission re Telemarketing Sales Rule - Debt Relief Amendments, Matter No. R411001 (Sept. 25, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00029.pdf.

grow out of control. Even debt settlement companies acknowledge that only about a third (34.4 percent) of debt settlement clients have at least 70 percent of their debts settled after three years in the program.[5] **The industry acknowledges that debt settlement is unsuccessful for two-thirds of their clients**. According to a Government Accountability Office investigation of debt settlement, even the industry's extremely low success rate is overly optimistic.[6] **The FTC and state attorneys general found that less than 10 percent of consumers successfully complete these programs**.[7]

- ***Even "successful" debt settlements can come with a high price***. The few consumers who are successful in debt settlement may find themselves with another unexpected bill: tax liability. Depending on the consumer's financial condition, the amount of savings realized from debt settlement can be considered taxable income. Credit card companies and other creditors may report a debt reduction to the IRS. Unless the consumer is considered insolvent, the IRS considers it income and the consumer will be on the hook to pay taxes on it.

- ***The problem is not limited to "bad actors" since the debt-settlement approach itself is flawed.*** Debt settlement schemes are a trap for most consumers because inherent in the industry's standard business model is the requirement that clients breach their contractual obligations with creditors.

CASE STUDIES OF DEBT-SETTLEMENT VICTIMS

- When Cipriano and Shelia, of Vallejo, CA, approached a Florida-based debt settlement company, the couple had approximately $60,000 in credit card debt. While grossly miscalculating the couple's monthly expenses and income, the firm advised them that they need only pay a total of $31,200.00, including the firm's fees, and that they'd save approximately $28,800 as a result. The firm took an initial service fee of $6,900 and continued collecting monthly "set-aside" funds in payments of $460 and later $230. The firm's method of evaluating the couple's ability to participate in a debt repayment plan not only was flawed, but the firm never provided any information to prove that they could secure more favorable terms from the settlement than the couple might obtain on their own or through bankruptcy. Ultimately they could not afford to save enough money to settle their debts and received none of the benefits from the debt settlement program that they expected.

- Sewnarine, of Newark, NJ, is a hardworking immigrant limo driver who owns his house and rents out rooms to make ends meet. When he lost his job for a short period, Sewnarine saw an ad by a debt settlement company and called. Sewnarine had limited literacy skills and could not read and understand the agreements he signed. Even

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[5] Letter of Andrew Houser of The Association of Settlement Companies (American Fair Credit Council) to the Federal Trade Commission (Mar. 8, 2010), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00334.pdf at 10 (describing the result of TASC's survey of its members, including the 14 of its 20 largest members).

[6] GAO Report at 10-11 ("[F]ederal and state agencies have raised concerns with the methodology behind TASC's data." "When these agencies have obtained documentation on debt settlement success rates, the figures have often been in the single digits.")

[7] Ibid.

though he was unemployed and had no income other than his rental income, the debt settlement company took $1,200 from his account and eventually lowered his payments to $567 per month. Sewnarine paid a total of $5,152 to the debt settlement company. He quit the debt settlement when he was sued by his creditors for debts of $13,000 and $5,000. Despite having paid over $5,000 to the debt settlement company, Sewnarine was told he didn't have enough funds to settle either debt. The debt settlement company kept over $5,800 in fees when Sewnarine quit the program, despite having settled none of his accounts. Shortly after, the debt settlement company filed for bankruptcy, leaving Sewnarine with no recovery whatsoever.

- Perry of Highland Lakes, NJ, is a union glazier who started out with $60,000 in unsecured debt. Although he was current on all of his debts, Perry saw an advertisement for a debt-settlement company in November 2009, and jumped at their offer that for $500 per month he could be debt free in three to four years. He started paying into their "savings account" and was immediately sued by two large credit card companies. Although Perry paid $9,510 to the debt settlement company, they told him he didn't have enough money in his "account" to settle so he'd have to have a default entered or file an answer. Perry is now filing a Chapter 13 bankruptcy. His credit has been ruined as a result of his dealing with the debt-settlement company.

WHAT TO AVOID

Steer clear of any companies that:

- **Make promises that unsecured debts can be paid off for pennies on the dollar.** There is no guarantee that any creditor will accept partial payment of a legitimate debt. Your best bet is to contact the creditor directly as soon as you have problems making payments.

- **Require substantial monthly service fees and demand payment of a percentage of what they've supposedly saved you.** Most debt settlement companies charge hefty fees for their services, including a fee to establish the account with the debt negotiator, a monthly service fee, and a final fee-- a percentage of the money you've allegedly saved.

- **Tell you to stop making payments or to stop communicating with your creditors**. If you stop making payments on a credit card or other debts, expect late fees and interest to be added to the amount you owe each month. If you exceed your credit limit, expect additional fees and charges to be added. Your credit score will also suffer as a result of not making payments.

- **Suggest that there is only a small likelihood that you will be sued by creditors.** In fact, this is a likely outcome. Signing up with a debt settlement company makes it more likely that creditors will accelerate collection efforts against you. Creditors have the right to sue you to recover the money you owe. And sometimes when creditors win a lawsuit, they have the right to garnish your wages or put a lien on your home.

- **State that they can remove accurate negative information from your credit report.** No company or person can remove negative information from your credit report that is accurate and timely.

HOW TO GET REAL HELP FOR DEBT RELIEF

Many different kinds of services claim to help people with debt problems. The truth is that no single solution will work for everyone. Bankruptcy is an option that makes sense for some consumers, but it's not for everyone. For example, the National Association of Consumer Bankruptcy Attorneys and its individual consumer bankruptcy attorney members do not encourage every person who looks at bankruptcy to enter into it. What makes sense for each consumer will depend on their individual circumstances:

- If you have just a single debt that you are having trouble paying (a single credit card debt for example) and you have cash on hand that can be used to settle the debt, you may be able to negotiate favorable settlement terms with the creditor yourself. Creditors typically require anywhere from 25 to 70 percent on the dollar to settle a debt so you will need that much cash for a successful offer. Be sure to get an explicit written document from the creditor spelling out the terms of the debt settlement and relieving you of any future liability. Also be prepared to pay income taxes on any of the forgiven debt.

- If, like most people, you owe multiple creditors and do not have the cash on hand to settle those debts, you may want to consult a non-profit credit counseling agency to see if there is a way for you to get out of debt. But make sure to check it out first: Just because an organization says it's a "nonprofit" there is no guarantee that its services are free, affordable or even legitimate. Some credit counseling organizations charge high fees (which may not be obvious initially) or urge consumers to make "voluntary" contributions that may lead to more debt. The federal government maintains a list of government-approved credit counseling organizations, by state, at www.usdoj.gov/ust. If a credit counseling organization says it is government-approved, check them out first.

- Consult with a bankruptcy attorney about your options. Bankruptcy is a legal proceeding that offers a fresh start for people who face financial difficulty and can't repay their debts. If you are facing foreclosure, repossession of your car, wage garnishment, utility shut-off or other debt collection activity, bankruptcy may be the only option available for stopping those actions. There are two primary types of personal bankruptcy: Chapter 7 and Chapter 13. Chapter 13 allows people with a stable income to keep property, such as a house or car, which they may otherwise lose through foreclosure or repossession. In a Chapter 13 proceeding, the bankruptcy court approves a repayment plan that allows you to pay your debts during a three-to-five year period. After you have made all the payments under the plan, you receive a discharge of all or most remaining debts. For tax purposes, a person filing for bankruptcy is considered insolvent and the forgiven debt is *not* considered income. Chapter 7 also eliminates most debts without tax consequences, and without any loss of property in over 90 percent of cases. To learn more about bankruptcy and whether it makes sense for you, go to http://www.nacba.org/Home/AttorneyFinderV2.aspx.

ADDITIONAL RESOURCES:

- Center for Responsible Lending: Debt Settlement (http://www.responsiblelending.org/other-consumer-loans/debt-settlement/)

- Federal Trade Commission: Debt Relief Services (http://ftc.gov/bcp/edu/microsites/moneymatters/dealing-with-debt-relief-services.shtml)

- National Association of Consumer Bankruptcy Attorneys (http://www.nacba.org)