

Committee Staff:
Lacey Clarke
Legislative Counsel

Damien Butvick
Legislative Policy Analyst



Committee Report of the Governmental Affairs Division
Robert Newman, Legislative Director
Alix Pustilnik, Deputy Director, Governmental Affairs

COMMITTEE ON CONSUMER AFFAIRS
Hon. Daniel R. Garodnick, Chair

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Oversight: Debt Settlement Companies

I. INTRODUCTION

On Thursday, November 18, 2010, the Committee on Consumer Affairs, chaired by Council Member Daniel R. Garodnick, will hold an oversight hearing on the topic, “Debt Settlement Companies.” Those invited to attend include the Department of Consumer Affairs, the Office of Financial Empowerment, representatives from the debt settlement industry, various consumer advocacy organizations and other interested parties.

II. BACKGROUND

The recent economic recession has resulted in lost jobs, diminished income, and increased levels of consumer debt throughout the country. The combination of a harsh economic climate and increased regulation of traditional consumer debt relief methods, including bankruptcy and credit counseling, caused the debt settlement industry to flourish. Historically, consumers relied on non-profit credit counseling services to negotiate debt management plans (DMP) with creditors, often resulting in payment plans featuring reduced interest rates or forgiveness of late payment penalties. In New York State, credit counselors are referred to as budget planners and are licensed and regulated by the Banking Department.¹ In recent years, for-profit debt settlement companies have arisen as an alternative for consumers who could not afford or were uninterested in establishing a DMP.

While a budget planner works with a consumer and the consumer’s creditors to establish a repayment plan, often amortized over 3-5 years, a debt settlement company negotiates with the consumer’s creditors to accept a lump sum payment for less than the total amount of the consumer’s debt. Typically, a debt settlement company will require a

¹ NY CLS Bank Article 12-C (2010)

consumer to establish and make monthly deposits into a bank account in order to create a balance large enough to permit negotiation of a lump sum payment with the creditor. Debt settlement companies often charge advance fees for their services, however, in addition to monthly service fees, regardless of whether the company has begun negotiations with the creditor or is able to ultimately secure a settlement.²

According to a April 2010 report by the United States Government Accountability Office (GAO), the vast majority of settlement companies the GAO contacted: (i) collected fees from consumers before settling debts, (ii) allocated monthly consumer payments entirely to fees for up to 4 months prior to saving money for a settlement, and (iii) advised consumers to stop paying creditors.³ Additionally, many companies claimed suspiciously high success rates for settlements despite the fact that the Federal Trade Commission has found that fewer than 10 percent of consumers complete debt settlement programs.⁴ Even the industry's own figures show that only 3 years after enrolling with a debt settlement company, only 34% of enrolled consumers have completed their settlement programs and paid off their creditors.⁵

Debt settlement companies have claimed many victims, including a New York woman who entered into an agreement with a debt settlement company and ended up paying over \$2000 more than was due on her debt. The debt settlement company included her as a success story.⁶ In another case, a consumer deposited more than \$3700 into an account set up by a debt settlement company, yet after nine months the account

² United States Government Accountability Office, "Debt Settlement: Fraudulent, Abusive and Deceptive Practices Pose Risk to Consumers." Testimony Before the Committee on Commerce, Science, and Transportation, US Senate. April 22, 2010 at 3-5.

³ *Id.* at 6-9.

⁴ *Id.* at 10.

⁵ Goodman, Peter S. "Peddling Relief, Firms Put Debtors in a Deeper Hole" NY Times, June 19, 2010.

⁶ *Id.*, at 1.

held only \$1470 and none of the consumer's debts had been paid. The debt settlement company had collected the rest of the money as fees. When the same consumer was sued by a creditor to collect more than \$5000 owed on a credit card debt, the settlement company told her they could not help because she did not have enough money in her account to settle the debt. She subsequently filed for bankruptcy.⁷

Complaints about debt settlement companies ballooned in recent years. 21 states have brought more than 125 suits alleging deceptive practices and/or fraud since 2004 and the FTC reports that consumer complaints pertaining to settlement companies doubled between 2007 and 2009.⁸ In 2009, New York Attorney General Andrew Cuomo issued subpoenas to fourteen debt settlement companies in order to investigate claims that such companies fraudulently tout extremely high success rates and ultimately lead consumers into financial crisis.⁹

III. Federal Regulation

a. Federal Trade Commission

In July 2010, the Federal Trade Commission (FTC) announced amendments to the Telemarketing Sales Rules aimed at providing greater protections to consumers who contract with debt settlement firms. These amendments went into effect October 27, 2010. Under the amended rules, debt relief businesses - including debt settlement, debt negotiation and credit counseling companies - are prohibited from charging clients up-front fees and cannot collect any fees at all until: (i) at least one of the client's debts has

⁷ Goodman

⁸ Id.

⁹ "Attorney General Cuomo Announces Nationwide Investigation Into Debt Settlement Industry", Press Release, May 7, 2009.

been successfully negotiated; (ii) the client has reached a specific agreement with the creditor; and (iii) the client has made at least one payment to the creditor.¹⁰

The amended rules also require debt settlement firms to disclose a number of important facts to potential clients prior to signing a contract. For example, a firm is now required to disclose all its service fees and refund policies, as well as the estimated length of time that the firm expects it will take to negotiate a debt settlement agreement.¹¹ A firm must also inform a potential client how much money he or she will need to save before a settlement agreement can be reached as well as of the potential repercussions of failing to make timely payments to creditors, such as damaged credit, monetary penalties and potential legal action.¹² Finally, if a firm requires that a client set aside funds, the firm is required to ensure that the account is at an insured financial institution and to disclose to a client that he or she: (i) owns those funds; (ii) can withdraw from the contract at any time without incurring a penalty; and (iii) will receive all the money in the account (minus permitted fees) if he or she terminates his or her contract with the firm.¹³

The amended rules also preclude a debt settlement firm from making false or unsubstantiated claims about its service to lure in potential clients, including but not limited to claims about: (i) amount of money a client could expect to save through a firm's service; (ii) the length of time required to achieve the goals; (iii) the amount of money a debtor must accumulate before any negotiations can take place; (iv) the effect a debt settlement agreement will have on a debtor's credit rating; and (v) the firm's success

¹⁰ "Debt Relief Services & The Telemarketing Sales Rule: A Guide for Businesses," FTC, Available at <http://business.ftc.gov/documents/bus72-debt-relief-services-telemarketing-sales-rule-guide-business>, accessed on November 12, 2010, at 14.

¹¹ *Id.* at 8-9

¹² *Id.* at 9-10

¹³ *Id.*

rate and whether or not a firm is a nonprofit organization. Additionally, to stem the incidence of deceptive advertising, debt settlement firms must now also be able to provide empirical data to back up claims of success.¹⁴

Despite the enhanced protections the amended rules provide for consumers, the rules apply only to contracts that result from telephone calls either to or from the debt settlement firm. Transactions that take place entirely online or in person are not governed by these amended rules.¹⁵ These rules also do not enforce a cap on the fees a firm may charge its clients.¹⁶

b. The Debt Settlement Consumer Protection Act of 2010

In April 2010, United States Senator Charles E. Schumer (D-NY) introduced the Debt Settlement Consumer Protection Act of 2010. The bill mirrors several provisions of the new FTC rules, but would apply to all debt settlement companies regardless of the method of contact with a potential client and would impose a cap on the amount of fees a company could charge a client. Additionally, Senator Schumer's bill would require that firms provide clients with a detailed list of the services provided, fees to be charged and the firm's cancellation and refund policies.¹⁷ Debt settlement companies would be prohibited from accepting payment before settling a debt¹⁸ and fees would be significantly reined in: a \$50 cap for enrollment fees and service charges no greater than 5 percent of the amount saved through the debt settlement negotiations.¹⁹ The FTC and

¹⁴ Id., at 11.

¹⁵ Wyatt, E., "New Restrictions Placed on Debt Settlement Companies," *N.Y. Times*, July 30, 2010, at B2.

¹⁶ Mui, Y. Q., "New FTC rules aim at debt-relief industry; Consumers now protected from paying advance fees," *Washington Post*, July 30, 2010, at A16.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id.

state Attorneys general would enforce the provisions and consumers would have a private right of action if they are harmed as a result of a debt settlement firm.²⁰

IV. STATE REGULATION

a. Budget Planners and Debt Settlement Companies

Budget planners are currently licensed and regulated by the New York State Banking Department. State law defines a budget planner as “type B not-for-profit corporations [that] ‘distributes, supervises, coordinates or controls’ money on behalf of a consumer.”²¹ Specifically, a budget planner assists consumers in creating a debt management plan that can be used to help the consumer reduce his or her debt burden.²² Under a debt management plan, the consumer makes regular, periodic payments to the budget planner who will then make payments to the consumer’s creditors, from whom the planner has usually obtained such concessions as lowered interest rates or the elimination of certain fees.²³ Budget planners are permitted under state banking law to withdraw a modest set-up fee and monthly fee for services provided from the payments made by the consumer.²⁴ Under state law, budget planners must provide budgeting, education and counseling services to their clients; produce a written contract to the consumer disclosing fees, payments amounts, commencement and termination dates; and cancellation policies; send the client regular statements about their account activity; pay creditors in a timely

²⁰ Id.

²¹ State of New York Banking Department, “Jane Azia Testifies Before the New York assembly Committees on Consumer Affairs and Protection, Banks, and Judiciary on Debt Management Industry,” May, 14, 2009, Available at <http://www.banking.state.ny.us/sp090514.htm>.

²² Id.

²³ Id.

²⁴ Id.

manner; provide both their own toll-free telephone number as well as that of the New York State Banking Department; and file a surety bond with the superintendent.²⁵

Debt settlement companies are technically distinct from budget planners and therefore do not require a license to operate. Unlike budget planners, who do not negotiate a reduction in the principle owed,²⁶ debt settlement companies often require clients to set up bank accounts where the latter will continue to make monthly deposits until the account contains enough money for the firm to negotiate a reduced debt.²⁷ Moreover, since such bank accounts are controlled solely by the consumer and the firms do not directly control the funds therein, debt settlement firms are able to escape the designation of “budget planner” and, consequently, avoid the need for a license and regulation by the state.²⁸

b. Pending Legislation

To address the lack of state regulation of debt management firms, New York State Assemblywoman Audrey I. Pheffer (D-23) introduced Assembly Bill No. 7268-B, which would give New York State the tools to regulate debt management firms. Specifically, the bill would require that all debt management firms be licensed and bonded, require such firms’ in marketing materials to state that a debt settlement agreement may negatively affect a consumer’s credit rating, and cap fees for services. The bill would require numerous disclosures, including a description of the services to be provided, an estimate of the length of time to obtain a settlement, the amount of money necessary to complete the proposed settlement agreement, information about the financial risks of debt

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Supra* note 2.

²⁸ *Supra* note 21.

settlement, and the necessity of continuing to make scheduled payments to active creditors, to be made to a client before such client could sign a contract.²⁹ Consumers would be entitled to cancel a contract with a debt settlement firm at any time and receive a full refund of all funds in the consumer's account not yet paid to creditors. Debt settlement firms would be prohibited from collecting settlement fees prior to obtaining a settlement agreement with a creditor and actually paying the creditor and from making false claims or misrepresentations in marketing materials. Consumers would not have a private right of action against a debt settlement firm for any violation of the proposed legislation. The bill was introduced in March 2009 and was first discussed during an Assembly Consumer Affairs and Protection Committee hearing in May 2009. There has been no action on this bill since June 2010, when it was last amended.

V. LOCAL REGULATION

The City of New York currently addresses the growing problem of dubious debt settlement companies through its Office of Financial Empowerment (OFE), a program of Mayor Bloomberg's multi-faceted anti-poverty initiative, the Center for Economic Opportunity. The OFE, administered by the Department of Consumer Affairs (DCA), is the first comprehensive program of its kind in the country, focusing on identifying and ending exploitative financial practices that disproportionately affect those with the lowest incomes. It seeks to accomplish this mission by addressing five interconnected priorities: financial capacity, financial education, watchdog protection, strategic partnerships and best practices.³⁰ More specifically, the OFE has four strategic priorities: (i) to establish a network of high-quality financial service providers; (ii) to launch and coordinate large-

²⁹ A. 7268-B 2009-2010 Reg. Sess. (N.Y. 2010)

³⁰ Mayor Bloomberg Announces \$150 Million Annual Investment for Solutions to Challenges Raised by the Commission for Economic Opportunity. Press Release, December 18, 2006.

scale public awareness campaigns; (iii) to protect low income workers from predatory practices; and (iv) to identify and implement strategies to help low income people save and build assets.³¹

To address the growing problems associated with debt settlement companies, the OFE published a two-page flyer educating consumers about the dangers of debt settlement services, the most recent version of which was posted on its website in August 2010.³² The flyer highlights some of the disadvantages of contracting with debt settlement companies and offers tips on how to identify some of the practices that only serve to exacerbate one's financial predicament. As an alternative to these firms, the OFE recommends consumers visit one of its several Financial Empowerment Center locations for free debt counseling.

In addition to this outreach, Department of Consumer Affairs Commissioner Jonathan Mintz personally appealed to the FTC for stricter regulation of debt settlement companies, most recently in July 2010 when he sent a letter to the secretary urging a ban on advance fees for debt settlement services.³³

VI. ISSUES AND CONCERNS

The questionable practices of some debt settlement companies exacerbate what is already a precarious financial situation for many New Yorkers. In light of this, the Committee on Consumer Affairs is interested in learning what steps the OFE and, by extension, DCA have taken to mitigate the harmful effects of unscrupulous debt

³¹ Center for Economic Opportunity Strategy and Implementation Report, Appendix B, December 2007.

³² "Beware of Debt Settlement Services," Office of Financial Empowerment, Available at http://www.nyc.gov/html/ofe/downloads/pdf/pym_debt_settlement_flyer.pdf, Accessed on November 12, 2010.

³³ Mintz, J., Letter, Available at <http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00352.pdf>, Accessed on November 15, 2010.

settlement companies as well as what further steps they plan to take in the future. In particular, the Committee would like to know the extent to which DCA regulates debt settlement companies operating in New York City and whether it has ever investigated a debt settlement company for deceptive trade practices. The Committee is also interested in learning what outreach efforts the OFE has undertaken beyond publishing a two-page flyer to educate New Yorkers about the dangers of debt settlement firms. Finally, the Committee would like to know how the Council could work with DCA in addressing this issue going forward and what state and federal reforms still need to be made.