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S. Hrg. 108–545

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

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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Committee on Governmental Affairs

Norm Coleman, Chairman
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PROFITEERING IN A NON-PROFIT INDUSTRY: ABUSIVE PRACTICES IN CREDIT COUNSELING

REPORT

PREPARED BY THE

MAJORITY & MINORITY STAFFS
OF THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

RELEASED IN CONJUNCTION WITH THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS' HEARING
ON MARCH 24, 2004

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I. INTRODUCTION

Consumer debt has more than doubled in the past ten years.[1] The nation's credit card debt is currently $735 billion -- an average of nearly $7,000 per household.[2] Since 1996, more than one million consumers have filed for bankruptcy each year, with a record 1.66 million new filings in 2003.[3] 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. 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. The Internal Revenue Service has instituted a new program for reviewing the applications of credit counseling agencies for non-profit status and has initiated audits of fifty credit counseling agencies. The Federal Trade Commission and the Attorneys General of Illinois, Maryland, Minnesota, Missouri, and Texas have joined multiple private class actions in suing one aggressive actor, AmeriDebt and its related for-profit entities in venues across the country. Clearly, something is wrong with the credit counseling industry.

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 the problems that it is facing. The Subcommittee's investigation has revealed that AmeriDebt is not the only potential "bad actor" in the industry. Indeed, many of AmeriDebt's practices represent a pattern of abuse among several new entrants in the credit counseling industry.

II. EXECUTIVE SUMMARY

Credit counseling agencies ("CCAs") traditionally relied upon contributions from creditors or small fees from consumers to cover operational costs. The new entrants, however, have developed a completely different business model, using a for-profit model designed so that their non-profit credit counseling agencies generate massive revenues for a for-profit affiliate for 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 by the new entrants, including (1) the manner in which the new entrant was organized, (2) the extent of control exercised by a for-profit entity

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[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 *http://www.abiworld.org*.

over their non-profit CCA affiliate, and (3) the revenue received by 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 -- provide no bona fide education or counseling and place every consumer onto a debt management program at unreasonable or exorbitant charge.

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-1960's in an effort to stem the growing volume of personal bankruptcies. Most, if not all, of the original credit counseling agencies were members of the National Foundation for Credit Counseling ("NFCC").[4] NFCC member agencies were community-based, non-profit organizations that provided a full range of counseling, often in face-to-face meetings. 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.

From the outset, a popular credit counseling option was the "debt management plan" ("DMP"). In order to initiate a DMP, a consumer would authorize their credit counselor to contact each of the consumer's unsecured creditors -- primarily credit card companies. The counselor would 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 their credit counseling agency, 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 credit counseling agency -- 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 total loss from a bankruptcy, received some or all of the debts owed by the consumer. The credit counseling agency, 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 seemingly smoothly for several decades. NFCC credit counseling agencies charged nominal fees or requested contributions from consumers in order to cover their operational costs. Such fees or contributions would be used by a credit counseling

[4] For more information on the NFCC, visit the organization's website at *http://www.NFCC.org*.

agency to defray their costs for counseling and initiating and maintaining the DMP. Such fees and contributions were small in comparison to the creditor concessions received by the consumer. Today, the fees charged by the NFCC remain minimal. The average initial fee to set up a DMP with an NFCC agency in 2002 was $23.09 and the average monthly maintenance fee was $14.00.[5]

Growth in consumer credit card debt in the 1990s brought many new and aggressive entrants into the credit counseling industry. Since 1994, 1,215 credit counseling agencies have applied to the IRS for tax exempt status under Section 501(c)(3).[6] Over 810 of these applicants applied during 2000 through 2003.[7] There are currently 872 active tax-exempt credit counseling agencies operating in the United States.[8] Many of these new entrants were 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 for-profit corporations, which enter into contracts with non-profit CCAs to siphon off cash from the CCA. A common method used by for-profit entities to collect revenue from the CCA is to set itself up as a "back-office processing company," which would contract to provide data entry and DMP payment processing for the CCA in exchange for processing and other fees. 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 contracting 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

Because most states require corporations to be non-profit in order to perform credit counseling services, CCAs are almost exclusively organized as non-profits under 26 U.S.C. § 501(c)(3). 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.[9] No part of the corporation's net earnings may inure to the benefit of any individual or any private shareholder in the corporation.[10] 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.[11] Organizations apply for tax-exempt status with the IRS.[12] IRS Exempt Organizations Determinations Agents review each application and grant or deny tax- exempt status.[13] Once an organization is granted tax-exempt status, they must operate under

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[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] Everson letter, p. 2.
[9] 26 U.S.C. § 501(c)(3).
[10] Id.
[11] IRS Publication 557, Tax-Exempt Status for Your Organization (Rev. May 2003), p. 17.
[12] Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. September 1998).
[13] Everson letter, p. 6.

the requirements of § 501(c)(3) or risk losing their tax-exempt status. Each year, the tax-exempt organization must file a tax return which details their activities, revenues, and expenses.[14]

Credit counseling organizations have been recognized as proper tax-exempt entities for several decades. In 1969, the IRS affirmed that 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 though the use of films, speakers, and publications."[15] 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.[16] The budget plan services were to be "provided without charge to the debtor."[17]

In 1979, the U.S. District Court for the District of Columbia decided Consumer Credit Counseling Service of Alabama v. United States[18] which further described what activities could be performed by CCAs in conformity with their tax exempt status. 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."[19] As an "adjunct" to those principal activities, agencies may 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."[20] Only an "incidental" amount of revenue was realized by the agency through the debt management programs.[21]

A CCA is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest.[22] Even if a CCA has many activities which further charitable purposes, exemption may be excluded if the CCA also serves a private interest.[23] The language of § 501(c)(3) specifically prohibits inurement -- no part of a CCA's net earnings may inure to the benefit of any individual or "insider" such as an officer or director. "Inurement" is simply the unjust payment of money from a CCA to an individual.[24] Such payments are unjust if they exceed fair market value or are otherwise unreasonable.[25] "Private benefit" is a much broader concept, and involves benefits to anyone other than the intended recipients of the benefits conferred by the organization's exempt activities.[26] If a CCA is operated in such a

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[14] IRS Publication 557, supra, at p. 8.
[15] Rev. Rul. 69-441, 1969-2 C.B. 115.
[16] Id. at *2-3.
[17] Id. at *3.
[18] 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) (same).
[19] Id. at *3.
[20] Id. at *3-4.
[21] Id. at *5.
[22] Private Benefit Under IRC 501(c)(3), Topic H in the 2002 IRS Exempt Organizations Continuing Professional Education Technical Program, p. 135.
[23] Private Benefit Under IRC 501(c)(3), p. 135.
[24] Private Benefit Under IRC 501(c)(3), p. 135.
[25] Private Benefit Under IRC 501(c)(3), p. 138.
[26] Private Benefit Under IRC 501(c)(3), p. 139.

manner that an individual or other entity benefits to a substantial degree, then the CCA is deemed to be operating for a private purpose. That holds true even where the benefit conferred upon the private interest is reasonable and for fair market value.[27] Examples of private benefit include payments to outsiders for goods or services, "steering business to a for-profit company," and excessive compensation paid to employees (not officers or directors, which would be inurement).[28]

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 is subject to revocation. In lieu of having its exemption revoked, the IRS may instead choose to impose "intermediate sanctions" against the CCA. Intermediate sanctions may also be imposed upon certain individuals who are not employed by the CCA that have engaged in an "excess benefit transaction" with the CCA. 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.[29] Therefore, 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 sanctions. The sanction imposed upon such an individual is an excise tax equal to 25% of the excess benefit.[30] 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 will be assessed against the individual.[31]

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.[32] Although the FTC generally lacks jurisdiction to enforce consumer protection laws against bona fide non-profits, they 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," where 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.[33]

The Subcommittee has uncovered alarming abuses by three CCAs and their affiliates, as described in the following section.

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[27] 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).

[28] Private Benefit Under IRC 501(c)(3), p. 139.

[29] 26 U.S.C. § 4958(c)(1)(A). A "disqualified person" is someone who, at any time during the five years preceding an excess benefit transaction, was "in a position to exercise substantial influence over the affairs of the organization."

[30] 26 U.S.C. § 4958(a)(1).

[31] 26 U.S.C. § 4958(b).

[32] 15 U.S.C. § 45(a).

[33] 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).

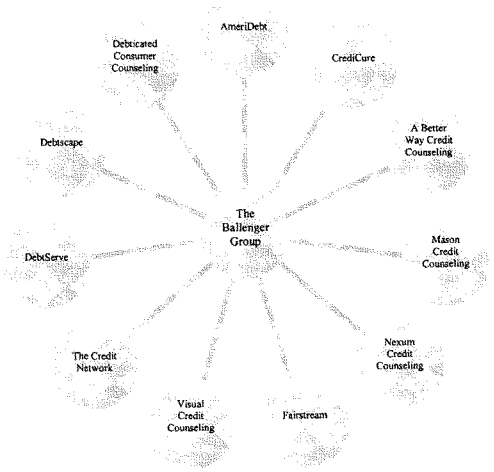
IV. AMERIDEBT, AMERIX, CAMBRIDGE COUNSELING: THREE CASE STUDIES

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, high-priced advertising blitzes, or expensive marketing campaigns. Their day-to-day operations were characterized by face-to-face meetings between consumers and credit counselors that last 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, 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 characteristics of 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. This Staff Report focuses on the following three major debt management groups: (1) the DebtWorks-Ballenger Group conglomerate, (2) the Ascend One-Amerix conglomerate, and (3) the Cambridge-Brighton conglomerate.

A. The DebtWorks-Ballenger Group Conglomerate

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



eleven CCAs exceeds $2.5 billion.[34]

(1) Formation of the DebtWorks-Ballenger Conglomerate

The DebtWorks-Ballenger conglomerate is organized and directed primarily by Andris Pukke and his wife Pamela Pukke. Andris Pukke entered the credit counseling industry by organizing and operating a for-profit CCA in Gaithersburg, Maryland, called Consumer Debt Resources.[35] 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 another non-profit CCA -- AmeriDebt, Inc. Pamela Pukke acted as vice president, secretary, and director of the new CCA.[36] Although not listed as an officer or director, Mr. Pukke regularly held himself out to be the president of AmeriDebt.[37]

After operating as a non-profit CCA for approximately three years, AmeriDebt decided to "spin off" its DMP processing function and turn it into a for-profit entity called DebtWorks, Inc., which was wholly owned and controlled by Mr. Pukke.[38] DebtWorks was incorporated on July 21, 1999, purchased the assets of AmeriDebt on September 1, 1999, and signed its first contract with AmeriDebt to provide DMP processing on the same day.[39] AmeriDebt simply moved its DMP enrollment employees to the building next door while the DMP processing function (DebtWorks) remained in AmeriDebt's original office space.[40] AmeriDebt then also opened "branch" DMP enrollment locations in New York and Florida. AmeriDebt was DebtWorks's 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 eleven non-profit CCAs in the DebtWorks-Ballenger conglomerate were organized by insiders of AmeriDebt or by friends of Mr. Pukke, including: (1) Edward Catsos, the managing director of AmeriDebt's Florida office, organized DebtServe;[41] (2) Edward's brother, James Catsos, who had served as AmeriDebt's secretary, formed Debticated Consumer Counseling with Mr. Pukke's brother, Eriks;[42] (3) Andrew Smith, who served as interim president for AmeriDebt, formed Fairstream; (4) William Sergeant, an AmeriDebt counseling manager, formed Debtscape;[43] (5) Jeffrey Formulak and Richard Brennan,

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[34] Letter from Ballenger to Subcommittee, dated 11/26/03, at Ex. A.
[35] Subcommittee interview of Ballenger representatives (03/12/04).
[36] Articles of Incorporation dated 12/23/96 (originally named Consumer Counseling Services, Inc.); AmeriDebt Form 1023 dated 03/19/97.
[37] Subcommittee interview of Ballenger representatives (03/12/04).
[38] Articles of Incorporation of DebtWorks, Inc., Bates DWS 001538-1541.
[39] Articles of Incorporation of DebtWorks, Inc., Bates DWS 001538-1541; Asset Purchase Agreement between AmeriDebt and DebtWorks dated 09/01/99, Bates DWS 001526-1535; Fulfillment Agreement between AmeriDebt and DebtWorks dated 09/01/99, Bates DWS ******. AmeriDebt has made a dubious assertion 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 (02/27/04).
[40] Subcommittee interview of AmeriDebt representative (02/27/04).
[41] Subcommittee interview of AmeriDebt representative (02/27/04).
[42] Subcommittee interview of AmeriDebt representative (02/27/04).
[43] Subcommittee interview of AmeriDebt representative (02/27/04); AmeriDebt 1998 Form 990, p. 7.

respectively vice president and general counsel of AmeriDebt, formed CrediCure, and;[44] (6) Harold Patrie, an AmeriDebt counseling manager, formed The Credit Network.[45] 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.[46] 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 that could 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 received at AmeriDebt.[47]

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 501(c)(3) applications for almost every CCA in the current conglomerate, including AmeriDebt, A Better Way, Mason, Nexum, Visual, Credit Network, and Debticated. Moreover, in its Form 1023 application to the IRS, Mason listed its billing address at 12850 Middle Brook Road in Germantown, Maryland -- the address of DebtWorks. In addition, some of these CCAs, such as Debticated, signed a contract with DebtWorks before it was even granted non-profit status.[48] At least two CCAs – A Better Way and Visual Credit Counseling – received "start-up" loans from Infinity Resources Group, Inc. ("Infinity Resources"), a private lending institution wholly owned and operated by Mr. Pukke.[49] None of the Form 1023 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 DMP accounts and other business assets of DebtWorks.[50] The DebtWorks managers and Pukke executed a management buyout for over $43 million, financed with cash and a promissory note. Ballenger still owes Mr. Pukke and DebtWorks more than $37 million on the promissory note.[51] Since the DebtWorks-Ballenger transaction, Ballenger has continued the practice of assisting with the organization of CCAs. For example, both Debtserve and Fairstream received start-up capital of $250,000 by way of a loan, which Ballenger signed onto as a secondary guarantor.[52] In addition, both Debtserve and Fairstream were extended a functional line of credit by Ballenger for remittance of initial payments that otherwise would have been due to Ballenger.[53]

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[44] Subcommittee interviews of AmeriDebt representative (02/27/04) and Ballenger representatives (03/12/04).
[45] AmeriDebt 1998 Form 990, p. 7.
[46] Deed of Lease Agreement for The Credit Network, dated 05/13/99.
[47] 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,
[48] Fulfillment Agreement between Debticated and DebtWorks (08/01/00); Letter from IRS granting 501(c)(3) status to Debticated (08/16/00).
[49] A Better Way 2000 Form 990, indicating loan of $150,000 from Infinity Resources.
[50] Subcommittee interviews of Ballenger representatives (01/15/04, 03/12/04).
[51] Subcommittee interviews of Ballenger representatives (01/15/04, 03/12/04).
[52] Subcommittee interview of Ballenger representatives (03/12/04).
[53] Subcommittee interview of Ballenger representatives (03/12/04).

(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."[54] The CCA therefore 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 for a new DMP enrollment of $50, and an additional $25 per month for each active DMP.[55] 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 all income generated from consumers are supposedly "voluntary" contributions. In sum, Ballenger is dictating to a non-profit CCA that the CCA must pay it for DMP enrollment and maintenance, even if the new DMP is generating no revenue for the CCA.

(3) Private Benefit 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.[56] These figures document a 2359% increase in gross revenues during this time period. In all, between 1999 and 2002, DebtWorks obtained nearly $109 million in gross revenues from their "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 to Ballenger.[57] If the revenues received by DebtWorks from their affiliated CCAs were the result of excess benefit transactions, then intermediate sanctions should be considered.[58]

The DebtWorks-Ballenger conglomerate has continued to be lucrative for Ballenger since their acquisition of the DebtWorks DMP portfolio. In 2003, Ballenger realized gross receipts of $37,390,906.[59] Ballenger is owed an additional $10.7 million from affiliated CCAs, most of

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[54] See, e.g., Fulfillment Agreement between DebtWorks and Mason, Inc., 09/06/01.
[55] See, e.g., Fulfillment Agreement between Ballenger and A Better Way dated May 1, 2003, ¶ 4.1.
[56] DebtWorks 1999-2002 Form 1120S, Bates DWS 005411-5510. DebtWorks was unable to provide the Subcommittee with executed tax returns. This data was therefore taken from their draft returns.
[57] Treas. Reg. § 1.501(c)(3)-1(a), see also, Private Benefit Under IRC 501(c)(3), p. 135.
[58] 26 U.S.C. § 4958.
[59] Ballenger Accounts Receivable, Bates 01241.

which are in arrears. 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.**[60]

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 Way, Credit Network, and AmeriDebt all offer the same service.[61] Mr. Pukke and Infinity have had legal troubles for its treatment of consumers referred to it 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.[62] Nevertheless, between 1999 and 2002, Infinity Resources reported gross revenues of $8,364,488.[63] Referrals by a non-profit CCA to a for-profit entity for debt consolidation loans may not serve any educational or charitable purpose. Such referral activities, if more than insubstantial, will constitute a private benefit to Infinity Resources that is prohibited under the tax code and could lead to the revocation of the 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 should be considered.[64]

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[60] Debticated promotional materials faxed to a consumer (name withheld) on February 28, 2001 (emphasis in original).

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

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

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

[64] 26 U.S.C. § 4958.

(4) Harm to the Consumers

An example of how the DebtWorks-Ballenger conglomerate treated its clients is illuminating. The Subcommittee interviewed Jolanta Troy, who was a 46-year-old mother of two children, ages eleven and sixteen, when she heard an AmeriDebt radio commercial.[65] 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 pay her $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 on 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.

Ms. Troy's experience with AmeriDebt is, unfortunately, all too common. In addition, even if she had remained on AmeriDebt's DMP, the fee she was charged bears no relation to the value of the services that would have been provided to her by AmeriDebt. The initial DMP start-up fee charged by AmeriDebt and the other ten CCAs in the DebtWorks-Ballenger conglomerate 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 their initial fee 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.[66] 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. Aside from the initial start-up fee, the monthly DMP maintenance fees charged by Ballenger CCAs are based not upon AmeriDebt's actual costs or the value of the service to the consumer, but upon the number of credit cards on the plan -- generally $7 per credit card with a minimum of $20 per month and a maximum of $70 per month.

The profit motive of AmeriDebt is illustrated by the fact that their employees were given incentive bonuses for enrolling consumers in DMPs. The amount of the employee's bonus was based upon the number of consumers the employee enrolled in a DMP, as well as the amount of money collected from initiating the DMP.[67] Such an arrangement creates a clear conflict of

[65] Subcommittee interview with Jolanta Troy (03/15/04).
[66] NFCC 2002 Member Activity Report, p. 30.
[67] Subcommittee interview with former AmeriDebt employee (02/21/04).

interest since the AmeriDebt employee had a direct financial incentive to enroll consumers in DMPs, rather than give advice and counseling to a consumer who is not planning on enrolling in a DMP.

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.; (4) Clarion Credit Management, and; (5) Debt Management Group. The combined consumer debt under the management of these five CCAs exceeds $4.1 billion.[68]

(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.[69] An organizational chart of Ascend One and its affiliates is shown below:

In November 1992, Bernaldo 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 approached community colleges and

[68] Amerix Active Clients and Total Debt as of October 2003, Bates AMX 000001.
[69] Stockholders of Ascend One Corporation, Bates AMX 000008.

universities with the express purpose of proposing a "start-up" CCA.[70] In all, between 1998 and 2003, Amerix made presentations to almost thirty colleges and universities.[71] Under normal circumstances, a new CCA is required to apply to the IRS for 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 501(c)(3) organizations 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 501(c)(3) status. In this manner, American Financial Solutions ("AFS") was organized under the 501(c)(3) status of the North Seattle Community College Foundation.[72] Other Amerix CCAs such as Clarion Credit Management and Debt Management Group were similarly organized through a pre-existing 501(c)(3) entity that did not perform credit counseling services prior to their relationship with Amerix.[73] This practice effectively side-stepped the IRS's review of these new entrants into the credit counseling industry.

By facilitating the establishment of CCAs, Amerix's actions may demonstrate an intention to privately benefit by generating profits for itself. Ascend One also created additional for-profit corporations, including FreedomPoint, 3C Inc., and FreedomPoint Financial. FreedomPoint markets various specialized products such as "prepaid" credit cards and tax settlement products to consumers carrying significant debt.[74] 3C Inc. owns the "CareOne" service mark under which Amerix's CCAs are marketed to the public. FreedomPoint Financial serves as a mortgage broker and markets mortgage-related products to highly indebted consumers.

Some of the five CCAs in the Ascend One conglomerate refer 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."[75] Referrals by a non-profit CCA to a for-profit entity selling 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, will constitute a private benefit to Ascend One that is prohibited under the tax code and could lead to the revocation of the 501(c)(3) status of each CCA that makes such referrals.

(2) Control of the Affiliated Credit Counseling Agencies

Although Amerix does not formally own any of the five CCAs it helped to establish, Amerix exerts control over its associated CCAs through its Service Agreements. The Service Agreements are generally entered into by Amerix and a new CCA as part of the CCA's "start-up" arrangement. One key term in Amerix's Service Agreement is the requirement that the CCA 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

[70] Subcommittee interview of Amerix representative (01/30/04).
[71] List of colleges, universities, and non-profits presented with start-up opportunity, Bates AMX 001732.
[72] Letter from American Financial Solutions to Subcommittee, dated 11/19/03.
[73] Telephone interview of Clarion Credit Management representative (03/09/04).
[74] Subcommittee interview of Amerix representative (01/30/04).
[75] Treas. Reg. § 1.501(c)(3)-1(c), see also, Private Benefit Under IRC 501(c)(3), p. 135-39.

Commitments to First Time Calls per Counselor per month."[76] That means for every ten calls received by a CCA, at least three must be placed onto a DMP or the CCA is considered in breach of contract. Indeed, Amerix has taken legal action against one of their CCAs -- Genesis Financial Management, Inc. -- for its failure to maintain a 30% "assist rate."[77] Such contractual requirements essentially remove the discretion and judgment of a credit counselor as to which consumers they should enroll on DMPs.

In addition to the "assist rate" requirement, there are additional provisions in the Service Agreements that require each DMP to generate a minimum of $30 each month per DMP, termed the "revenue standard."[78] This requirement means that each CCA is contractually required to find money from some source for each DMP to meet the "revenue standard" in their Service Agreement. Each CCA is therefore required to generate income from the consumers or be considered in breach, regardless of the fact that all income generated from consumers is supposedly "voluntary."

The control granted to Amerix through the "assist rate" and "revenue standard" provisions shows 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.[79] This analysis is called the "organizational test" and is usually conducted during the 501(c)(3) application process. Amerix's practice of organizing CCAs through existing 501(c)(3) entities, however, deprived the IRS of the opportunity to determine the extent of control that Amerix will possess over their associated CCAs, when first established.

(3) Private Benefit to the For-Profit Corporations

On November 1, 2001, Mr. Dancel sold Genus's DMP portfolio to AFS for $17 million. The sale price of the Genus portfolio was based upon what future revenues would be generated by the portfolio from fees and fair share payments over a period of several years.[80] 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 $7.4 million of the outstanding loan.[81] Such "double payment" by AFS to Amerix for the same goods and services may constitute an excess benefit

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[76] Service Agreement between Amerix and Genesis Financial Management, Inc. dated 09/09/02, ¶ 14. Amerix's other CCAs are also required to carry an Assist Rate of 30%.

[77] Amerix Corporation v. Genesis Financial Management, Inc., No. 16 Y 181 00463 03, Before the American Arbitration Association, filed on 09/02/03.

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

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

[80] Subcommittee interview of AFS representative (01/22/04).

[81] AFS 2001 Form 990.

transaction under the Internal Revenue Code, and could subject Amerix to excise taxes on any excess benefit.[82]

Amerix and Ascend One enjoy great financial benefits under their contracts with the CCAs. Under the terms of Amerix's "Fee Schedule," Amerix is to receive between 50-85% of every dollar that is received from the CCA. If a consumer contacts an Amerix CCA directly and enrolls in a DMP, then Amerix is 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.[83] If the consumer contacts and enrolls with the CCA as a result of a referral from Amerix, Amerix is then entitled to 68% of all revenue generated by the DMP.[84] Finally, if a consumer enrolls in a DMP entirely through the "CareOne" website, then Amerix is entitled to *85%* of all revenue generated by the DMP.[85] Such pricing levels are 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 certainly 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.[86] These figures represent an increase of 120% in gross revenues during this time period. In all, between 1998 and 2002, Amerix received $386,453,223 in gross revenues -- all of which was generated by the "non-profit" credit counseling industry. Even if the amounts above were realized by Amerix through arms-length transactions at fair market value, the evidence suggests that the Amerix CCAs are not operating exclusively for exempt purposes and therefore may be in violation of tax regulations.[87] If the revenues received by Amerix between 1998 and 2002 were the result of excess benefit transactions, then intermediate sanctions may be appropriately assessed against Amerix.[88]

(4) Harm to the Consumers

Some Amerix CCAs charge excessive DMP fees, as described earlier. On the other hand, at least two Amerix CCAs – AFS and Debt Management Group – have 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 is greatly mitigated. Even these Amerix CCAs, however, fail the consumer by neglecting to provide adequate counseling and education.

Through Ascend One's "CareOne" website and through links from each of the Amerix CCA websites, a consumer is permitted to enroll in a DMP without a single contact with a counselor at any of the five CCAs in the Amerix conglomerate. Since a CCA's charitable status

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[82] 26 U.S.C. § 4958.
[83] See, e.g., Service Agreement between Amerix and AFS dated 10/18/02, Schedule B, p. 20.
[84] Id.
[85] Subcommittee interview of Genesis representative (02/24/04). The questionable practice of enrolling on a DMP entirely through the Internet is discussed below.
[86] Amerix/Ascend One 1998-2002 Form 1120S, Bates AMX 001452-1730.
[87] Treas. Reg. § 1.501(c)(3)-1(a); see also, Private Benefit Under IRC 501(c)(3), p. 135.
[88] 26 U.S.C. § 4958.

is largely dependent upon its providing educational services, there is no reasonable reading of IRS regulations or case law that would permit a CCA to enroll a consumer into a DMP without even interacting with a credit counselor.[89] Amerix employs between 30-40 "credit counselors" at its location in Columbia, Maryland. These "counselors" can provide DMP enrollment for Amerix's affiliated CCAs who cannot at that moment provide services to a consumer. For instance, if a consumer on the East Coast telephones AFS (located in Seattle) during the morning hours (before AFS is open for business) the caller is routed to Amerix in Maryland. From there, an Amerix "credit counselor" enrolls the consumer in a DMP. Any CCA that knowingly allows such services to be transferred to a for-profit company may be placing itself in jeopardy of losing their license in states that allow only non-profit agencies to provide credit counseling services. Currently, of Amerix's CCA affiliates, only AFS allows that call transfer to occur. Clarion Credit Management and Consumer Education Services, Inc. have done so in the past, while Debt Management Group and Genesis Financial Management, Inc. have allegedly never allowed such transfers.[90]

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.[91] 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 is unable to do so due to a lack of funds after making the payments required under their Service Agreement with Amerix.[92]

Consumers who actually enroll in a DMP with AFS are allowed access to a website that has some form of interactive program regarding spending and budgeting.[93] However, AFS does not permit consumers who do 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.[94] Although AFS received gross revenues of $75,165,312 during the following fiscal year, however, it managed to donate only 0.8% of that amount ($581,766) for the college's grants and scholarships.[95] Ironically, two years

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[89] 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).

[90] Subcommittee interview of Amerix representative (01/30/04). On March 15, 2004, AFS discontinued the "overflow origination" option of its Service Agreement with Amerix.

[91] Subcommittee interview of Amerix representative (01/30/04).

[92] Subcommittee interview of Genesis representative (02/24/04).

[93] Subcommittee interview of AFS representative (01/22/04).

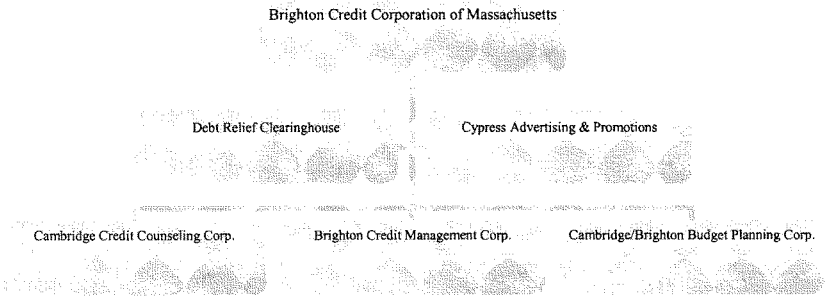
[94] Jeanne Lang Jones, *A strong foundation: $17M purchase makes college's nonprofit arm the largest U.S. credit counseling firm*, Puget Sound Business Journal, March 18, 2002.

[95] AFS 2002 Form 990, pp. 1-2, Bates AFS 01849-01882.

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.[96]

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 operations of the Cambridge-Brighton conglomerate are completely integrated and controlled by brothers John and Richard Puccio. Brighton Debt Management Services, Ltd. ("Brighton DMS") provides 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 501(c)(3) status pending. Debt Relief Clearinghouse Ltd. is the for-profit marketing arm for the conglomerate, and Cypress Advertising & Promotions, Inc. provides advertising services.[97] Brighton DMS processes 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.[98] The two entities operated out of the same location.[99] Cambridge Credit performed the DMP enrollment function while Brighton Credit performed the DMP processing services.[100] In 1996, after

[96] AFS 2000 Form 990, pp. 1-2.
[97] Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04).
[98] Cambridge Credit Corporation 1998 Form 1120S, Bates 00297-312; Brighton Credit Corporation 1998 1120S, Bates 00230-243.
[99] Id.
[100] Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04).

operating for approximately three 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.[101]

The Puccio brothers moved their principal operations to Massachusetts where they formed several corporations, including Cambridge Credit Counseling Corp. ("Cambridge") and Brighton Credit Corporation of Massachusetts ("Brighton Mass.").[102] 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.[103] Cambridge applied for 501(c)(3) status, which was granted by the IRS on February 12, 1998.[104] In terms of aggregate debt, Cambridge is currently the largest CCA in the Cambridge-Brighton conglomerate. The Puccio brothers, however, have recently organized two additional CCAs.

Despite the cease and desist order from the New York Banking Department, John and Richard Puccio incorporated another New York entity – Cambridge/Brighton Budget Planning Corporation ("Cambridge/Brighton") – on December 6, 1996.[105] Cambridge/Brighton currently operates in the same space previously occupied by Cambridge Credit and Brighton Credit.[106] Like Cambridge, Cambridge/Brighton is under contract with Brighton DMS for all processing services associated with their 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 outsources 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 conduct 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.[107] Both Cypress and Debt Relief operate from the same location as Cambridge/Brighton. Each of the Cambridge-Brighton CCAs pays Debt Relief and Cypress for their services. Therefore, although credit counseling is supposedly a "non-profit" industry, only two entities within the Cambridge-Brighton conglomerate have been organized as non-profits. All of the revenue realized by these entities is generated by consumers who enroll in DMPs.

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[101] Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04).

[102] 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").

[103] Cambridge 1997 Form 990, p. 16, Bates 00175; Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04). Brighton DMS was incorporated on March 21, 2003 to perform DMP processing for all Cambridge-Brighton CCAs.

[104] Letter from IRS to Cambridge dated 02/12/98, Bates 00002-4.

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

[106] Cambridge/Brighton 2002 Form 990, Bates 20643-20665.

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

(2) Control of the Affiliated Credit Counseling Agencies

Unlike the Amerix and Ballenger conglomerates that exercise control over their CCAs through the terms of complex service contracts, the principals of Brighton DMS actually own or control each of their three CCAs, Cambridge, Cambridge/Brighton, and Brighton Credit Management, as well as all of the affiliated for-profits entities, Brighton DMS, Debt Relief, Cypress, Cambridge Credit, and Brighton Credit. The Cambridge-Brighton non-profit CCAs (Cambridge and Cambridge/Brighton) are 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.[108] John Puccio serves as president and director of Cambridge/Brighton, and Richard Puccio serves as "strategic planner."[109] Additionally, the for-profit entities in the Cambridge-Brighton conglomerate are wholly or collectively owned by John and Richard Puccio:

CAMBRIDGE-BRIGHTON FOR-PROFIT ENTITIES	JOHN PUCCIO (% Ownership)	RICHARD PUCCIO (% Ownership)
Brighton Credit Management[110]	100%	0%
Brighton Mass.[111]	50%	50%
Brighton DMS	50%	50%
Debt Relief[112]	100%	0%
Cypress[113]	100%	0%
Cambridge Credit[114]	50%	50%
Brighton Credit[115]	50%	50%

Through their joint ownership and control of each entity in the Cambridge-Brighton conglomerate, John and Richard Puccio direct all operations and execute all contracts. Almost every possible operation of Cambridge is contracted out to a related for-profit entity. Cambridge pays Brighton DMS to provide processing for Cambridge's DMP portfolio.[116] Cambridge pays Brighton Mass. to lease its equipment, personnel, and software.[117] Cambridge pays Debt Relief for referrals of consumers[118] and pays Cypress to place advertising.[119] 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 conduct millions of dollars of business with one another without any written contract. For example, Brighton Credit Management (the CCA based in

[108] Cambridge Schedule of Officers Directors, Bates 01120-01125.
[109] Cambridge/Brighton 2002 Form 990, p. 4, Bates 20646.
[110] Brighton Credit Management 2002 Form 1120S, Schedule K-1.
[111] Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04); Brighton Mass. 1998 Form 1120S, Bates 00432.
[112] Debt Relief 2000 Form 1120S, Bates 00339.
[113] Cypress 2000 Form 1120S, Bates 00364.
[114] Cambridge Credit 1998 Form 1120S, Bates 00309.
[115] Brighton Credit 1998 Form 1120S, Bates 00240.
[116] Administrative Services Agreement between Cambridge and Brighton DMS dated 06/0103.
[117] Cambridge 2001 Form 990, p. 19, Bates 00085.
[118] Client Subscription Services Agreement between Cambridge and Debt Relief dated 01/01/03.
[119] Advertising Services Agreement between Cambridge and Cypress dated 04/01/99.

Florida) has no contract with Brighton DMS or Debt Relief, but they have conducted business with one another for almost three years. Such control of CCAs by for-profit organizations, whether under contract or not, may violate the "private benefit" prohibitions of the tax code.[120]

(3) Private Benefit to the For-Profit Corporations

The for-profit entities in the Cambridge-Brighton conglomerate have realized great private benefits from the Cambridge-Brighton CCAs. 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 Cambridge, and; (2) the for-profit entities in the current structure (Brighton Credit Corporation of Massachusetts, Debt Relief, Cambridge Credit, Brighton Credit, and Cypress) obtain large amounts of money from 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."[121] 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 created an artificial, "paper" debt that Cambridge would be obligated to pay back to them for 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, a non-profit agency (Cambridge) must 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 it was granted tax-exempt status. Cambridge Credit and Brighton Credit have received repayments on that "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 five years alone. This $14.1 million transfer may constitute an "excess benefit transaction" prohibited by the tax code.[122] Indeed, since Cambridge was arguably created in part for the purpose of generating $14.1 million for two related for-profit corporations, it may be said that it was not organized exclusively for non-profit purposes.[123]

Beyond the revenues generated by the "intangible assets" sale, Cambridge generates substantial additional revenues for the other for-profit entities in the Cambridge-Brighton

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[120] Private Benefit Under IRC 501(c)(3), p. 135-39.
[121] Intangible Assets Sale Agreement between Cambridge, Cambridge Credit, and Brighton Credit dated 11/27/96, Bates 00038-46.
[122] 26 U.S.C. § 4958(c)(1)(A), (f)(1)(A).
[123] Treas. Reg. § 1.501(c)(3)-1(a).

conglomerate. In the Ascend One-Amerix and DebtWorks-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 the DebtWorks-Ballenger conglomerate all revenues streamed to for-profit DebtWorks/Ballenger. In contrast, the revenue streams are more diversified in the Cambridge-Brighton model. The three CCAs (Cambridge, Cambridge/Brighton, and Brighton Credit Management) distribute 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 are allocated to Brighton DMS (formerly Brighton Mass.), Debt Relief, and Cypress.

The primary function of for-profit Brighton DMS/Brighton Mass. is 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 are transferred among related entities.

Since 1998, Brighton Mass./Brighton DMS has realized gross receipts in excess of $40.5 million.[124] 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 is paid $750 for each consumer it transfers to a CCA that enrolls in a DMP.[125] Through 2002, Debt Relief's referrals resulted in gross receipts of over $25 million.[126] 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.[127]

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 the founders of Cambridge – Richard and John Puccio – had combined salaries in 2001 from Cambridge alone of $1,248,000. That means they each received a salary in 2001 of $624,000 for running a non-profit entity. In addition they received compensation from related organizations of more than $600,000 in that same year. As noted above, IRS rules say that organizations should not qualify as non-profit corporations if they are organized or operated for the benefit of individuals associated with the corporation and if they are not operated exclusively to accomplish charitable or educational purposes.

The IRS has initiated an audit of Cambridge.[128] 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" amount to an excess benefit transaction and to what extent, if any,

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[124] Brighton Mass. 1998-2002 Form 1120S, Bates 00423, 00412, 00400, 00388, 00375.
[125] See, e.g., Client Subscription Services Agreement between Cambridge and Debt Relief dated 01/01/02, at ¶ 4(b).
[126] Debt Relief 2000-2002 Form 1120S, Bates 00333, 00324, 00313.
[127] Cypress 1999-2002 Form 1120S, Bates 00369, 00359, 00350, 00341.
[128] Subcommittee interview of Cambridge and Brighton DMS representatives (01/20/04).

excise taxes should assessed.[129] Additionally, the IRS should determine whether Cambridge was organized or now operates for the a private benefit and whether, if so, its 501(c)(3) status should be revoked.[130] Finally, the IRS should examine the organization and operation of Cambridge/Brighton, whose 501(c)(3) status is currently pending. Since Cambridge/Brighton was designed along the same lines as Cambridge, the IRS should fully scrutinize their application in order to determine whether it is organized and operated for the public benefit and that its assets do not inure to the benefit of any private individual.[131]

(4) Harm to the Consumers

The Subcommittee interviewed a former client of Cambridge, Mr. Raymond Schuck, to evaluate their services. Mr. Schuck told the Subcommittee that, in the summer of 2001, he was $90,000 in debt distributed among nine credit cards.[132] After hearing about Cambridge on the radio, he called them and spoke with a counselor. The counselor suggested a debt management plan, and promised a reduction in interest rates. After answering a list of questions about his various credit cards, the counselor told Mr. Schuck that his monthly payment would be $1,949 and that Cambridge would charge him 10% of his monthly payment for their services, or $194 a month. Mr. Schuck thought that $194 was high, but knew very little about the industry and assumed that, because Cambridge was a non-profit, he could trust them.

The counselor told Mr. Schuck 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 started getting calls from some of his creditors asking why he had not made any payments. The creditors told him that they were unaware that he was on a DMP with Cambridge and stated that no payments had been received.

Mr. Schuck called Cambridge to find out what was going on. He found it very difficult to contact someone in customer service who could tell him about his account. 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 was shocked by this information, and told the Subcommittee that had he known of that in advance, he would have searched for a different credit counseling agency. Mr Schuck said he would never have agreed to give Cambridge almost $2,000 when that money could have gone to his creditors. Ultimately, Mr. Schuck declared bankruptcy. Mr. Schuck 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.

The fee structure of the Cambridge-Brighton CCAs is the highest of any CCA that the Subcommittee investigated.[133] The fees are clearly excessive and bear no relation to the actual expense of initiating and maintaining a DMP. The initial start-up fee charged to a consumer --

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[129] 26 U.S.C. § 4958.

[130] 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."

[131] Treas. Reg. § 1.501(c)(3)-1(c)(2).

[132] Subcommittee interview with Raymond Schuck (02/24/04).

[133] 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.

the "Payment Design Fee" -- is typically set in an amount equal to the consumer's monthly payment. The vast majority of monthly payments are several hundred dollars and many are in excess of $1000 or even close to $2000. As such, the Cambridge-Brighton CCAs routinely charge a consumer $500 or $1000 for merely setting up a DMP. Like AmeriDebt and other Ballenger CCAs, the Cambridge-Brighton CCAs retain this fee instead of sending it to creditors. Also like AmeriDebt, the Cambridge-Brighton CCAs often fail to adequately disclose that fact. Like many other consumers who dealt with Cambridge, Mr. Schuck was not informed that his "Payment Design Fee" of $1,949 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 Cambridge's actual expenses but was instead set at 10% of the monthly DMP payment. Therefore, a consumer who is 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 $14.00.[134]

The "credit counselors" in the Cambridge-Brighton CCAs are given bonuses for enrolling consumers in DMPs. The amount of the bonus is a function of the amount of start-up fees that the counselor generates each month.[135]

Like the counselors at many other new entrants, Cambridge-Brighton "credit counselors" 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 $1,949 to initiate his DMP.

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 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. Self-Regulation

The credit counseling industry has two major associations, the NFCC and the Association of Independent Consumer Credit Counseling Agencies ("AICCCA"), each of which has issued mandatory membership standards for their members. The NFCC standards, adopted through the Counsel on Accreditation for Children and Family Services ("COA"), are the more restrictive of the two. If applied throughout the industry, the Subcommittee staff believes these professionals standards would go a long way toward addressing the abusive practices identified in this Report. For example, each NFCC member must demonstrate that it:

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[134] NFCC 2002 Member Activity Report, p. 30.
[135] Subcommittee interview of former Cambridge employee (02/02/04).

- Allocates a reasonable percentage of operating expenses, to a variety of consumer educational programs on money management, budgeting and the intelligent use of credit.[136]

- Ensures that certified counselors provide a comprehensive one-on-one money management counseling interview with each client.[137]

- Keeps fees as low as possible. Agencies are specifically forbidden from charging excessively large or unconscionable fees. At no time can a person be refused service due to an inability to pay the fee.[138]

AICCCA maintains similar standards as part of the code of practice its members must adhere to. 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 adherence to a standard named ISO 9000 as ensuring that they also adhere to high standards. It is therefore important to understand the difference between these claims and the NFCC and AICCCA requirements. ISO 9000 is a generic set of quality assurance standards that are followed by many large businesses. It is not specific to the credit counseling industry. Pursuit of ISO 900 standards has been helpful as a first step toward improving performance because it requires careful documentation of business procedures. But ISO 9000 does not affect business products or services. For instance, nothing in ISO presumes to tell an entity how much it can charge, who it can do business with, or even what quality of service it should provide.

Self-regulation also has certain limitations. First, although the standards are mandatory on an association's membership, joining the association itself is voluntary. CCAs that wish to operate pursuant to lower business standards or no standards can simply refuse to join. By not having to comply with strict standards, 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 credit counseling agencies 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 credit counseling agencies by providing them with a percentage of the payments made by the debtors that the agencies counsel. Often referred to as "fair share payments," these payments are intended to reimburse some CCA costs in exchange for the agencies' positive work in helping debtors repay their debts. Many of the largest creditors have developed standards to determine

[136] NFCC Member Quality Standard #03.00.
[137] NFCC Member Quality Standard #04.00.
[138] NFCC Member Quality Standard #09.00.

which CCAs are eligible to receive fair share payments. If well developed and carefully enforced, the Subcommittee staff believes these standards could also 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"), that 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.[139] 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 National Foundation for Credit Counseling ("NFCC")[140] 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.[141] 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 expenses.[142] 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.[143]

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 percent of the aggregated debtor payments. In recent years, as the expense associated with fair share payments increased, at times taking up 25-30 percent of the budgets of the collections departments at major creditors,[144] some creditors have reduced 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

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[139] 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 all other budget requirements. A consumer would often meet with a counselor more than once and for significant lengths of time (over an hour). After a budget analysis, the counselor would make a recommendation for the consumer to readjust their budget, utilize a debt management plan, and seek legal assistance (possibly to declare bankruptcy).

[140] For more information on the NFCC, visit the organization's website at *http://www.NFCC.org*.

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

[142] Historically, 60% of NFCC funding came from creditors and 40%came from charities. Subcommittee interview of NFCC representatives (01/12/04).

[143] In 2002, the average fee among NFCC members for establishing a debt management plan was $23.09. The average monthly fee was $14.00. Many NFCC members still do not charge the consumer any fee for their services.

[144] Subcommittee interview with Citigroup representatives (03/09/04); Bank One operating expenses spreadsheet, Bates BO 253-254.

of fair share payments each credit counseling agency receives to the success rates of the DMPs that the creditor receives from each CCA.[145]

In addition to their historic funding relationship with non-profit credit counseling agencies, major creditors had 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.[146] In 1996, the NFCC entered into an agreement with the FTC to require its members to disclose the fact that they receive payments from the 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, a new breed of CCA began to enter the market. These credit counseling agencies used more technologically advanced practices to implement their DMPs through innovative software. They also launched heavily funded advertising and marketing campaigns using late night television ads 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 changed the industry from a local, storefront, client-specific operation to a nationwide, mass-marketed sale of a product -- the DMP.

As consumer debt reached new heights during the late 1990s and early 2000s, the debt management plan became the method of choice recommended to consumers by many of the new CCAs to resolve their 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 fees.

Even without agencies aggressively pushing them, the rapid increase in consumer debt over the last decade would likely have produced a sharp increase in the use of DMPs. As fair share payments increased, it should not surprise anyone that creditors began to examine the merits of this growing expense. These inquiries indicated 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 and fees were unnecessarily and incorrectly placed on DMPs. As a result, the creditors heightened the level of scrutiny of the CCAs and their proposed debt management plans. Creditors began issuing more detailed CCA and DMP standards, in effect becoming a regulator of credit counseling practices.

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[145] 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.

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

(2) Three Creditor Models

The Subcommittee interviewed three major creditors to gain an understanding of the competing interests of the industry as well as actions taken by the creditors towards CCAs. These creditors are Bank One Delaware, N.A. ("Bank One"), MBNA America, N.A. ("MBNA"), and Citigroup, Inc. ("Citigroup"). The Subcommittee found that all three issue 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[147] and a performance-based model. Before Bank One will even consider making fair share payments, an agency must make debtor payments and submit debtor proposals electronically and not be involved in any pending litigation. The agency's business eligibility is then assessed. The following minimum standards must be met:

- Accreditation of the agency[148]
- Certification of counselors
- Fees meet Bank One guidelines
- Marketing budget and content are approved by the CCA's board

Once these criteria are met, Bank One will make a maximum of 9 percent fair share payments to an agency. This maximum is broken into two components. If a CCA meets the business eligibility requirements it will receive 2 percent. The CCA may receive up to an additional 7 percent depending upon the performance of the portfolio.[149] This measures the average fixed payment and the default rate of the agency, both equally weighted to provide a maximum of 3.5 percent in additional fair share payments for each criteria. In addition, the agency must also meet a New Inventory Criteria. This criteria measures whether the agency is continuing to sign up new Bank One card members or just administering old Bank One accounts. New Inventory Criteria requires a growth rate of 0.25 percent.

(b) MBNA

MBNA also utilizes a minimum standard model coupled with a performance-based model.[150] MBNA has set minimum requirements that must be met before an agency qualifies for any fair share payments:

- Agency must be accredited.

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

[148] Industry-accepted accreditation organizations include COA, BSI, BVQI, and ISO 9000 with an accepted "Code of Practice." NFCC and AICCCA have developed a code of best practices for their members which address their operations.

[149] Subcommittee interview of Bank One representatives (02/10/04). New model implemented July 2003.

[150] Subcommittee interview of MBNA representatives on (02/17/03). New model implemented in February 2004.

- Agency must be a non-profit under IRC § 501(c)(3).
- Agency may not be affiliated with any entity that is not a 501(c)(3) agency.[151]
- All debtor payments and proposals must be transmitted electronically.
- A full-budget disclosure must be attached to all proposals.
- No start up fee may exceed $75, no monthly fee may exceed $50, and there can be no termination fees.
- At least 90 percent of the CCA's consumers must have completed a full budget disclosure.
- At least 85 percent of the DMP proposals submitted by the agency must meet MBNA's criteria for establishing a DMP.

Upon meeting these criteria, an agency's portfolio is measured by its payment volume and portfolio vintage. Thus, the older the account, the larger the percentage of fair share available, starting with 2 percent for brand new accounts and rising to 15 percent for accounts that last thirty-six months.

(c) Citigroup

Citigroup has recently introduced a form of fair share payments new to the credit counseling industry.[152] Citigroup refers to this method of disbursing fair share payments as a "Grant Program." Under this program, Citigroup will pay CCAs according to their "perception of the agency's needs and the benefits they provide to the customer and the community."[153] With the Citigroup grant program, payments will be made in quarterly advances in a lump sum contribution.[154] The amount of payment will reflect Citigroup's judgment of the value that the CCA is delivering to consumers, based on a twenty-nine question application. The questions in the Citigroup application address many of the same issues utilized by other industry leaders to assess CCAs.

(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 CCAs depend on fair share payments as a major source of revenue, they are obligated to comply with creditor standards, which means creditors can 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 prohibiting CCAs from affiliating with for-profit entities addresses the core of the profiteering problem. Some of the performance-based requirements encourage debt management plans that set realistic goals for debtors.

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[151] MBNA allows outsourcing only for payment processing.
[152] Subcommittee interview with representatives of Citigroup (02/20/04). New model implemented on January 1, 2004.
[153] Citigroup model letter to CCA dated November 4, 2003, Bates CC 00073-74.
[154] Id.

As with the professional standards set by credit counseling associations, however, 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 the requirements. Creditors informed the Subcommittee that they feel limited in their ability to police the industry, and some expressed a reluctance to condition the concessions they provide to a debtor upon the debtor's choice of a particular agency. Some creditors also worry about appearing to favor some agencies over 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 which can translate into higher costs and administrative burdens for agencies.[155] Creditors respond that, while uniformity in criteria for fair share payments may be desirable, current antitrust laws may inhibit 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 the terms a creditor will offer debtors under a DMP.

CCAs also assert that the ambiguous tone of some policies and an inability to obtain creditor clarification complicates the job of administering plans. For example, Citigroup announced its new Grant Program on November 4, 2003.[156] Some CCAs have complained that the criteria for determining fair share payments under this program are subjective, leaving agencies unsure of how to operate their practices in order to maximize their Citigroup fair share payments. Citigroup also required the CCAs to respond by November 24, 2003, within twenty days of receiving a notice of the change in policy,[157] which CCAs complain left them with little understanding of what to expect from the creditor and an inability to plan for their operating budgets.[158]

At the same time, 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 ending abusive practices in the credit counseling industry.

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[155] Subcommittee interviews with NFCC and AICCCA representatives (10/16/03, 10/09/03).
[156] Citigroup model letter to CCA dated November 4, 2003, Bates CC 00073-74.
[157] Id. at Bates CC 00073–74.
[158] A CCA may make a request of Citigroup in advance for their quarterly payment, however it is unknown the weight Citigroup affords any request. Citigroup will pay the CCA according to their perception of its needs and the benefits it provides to its customers and the community. Subcommittee interview of Citigroup representatives (02/20/04).

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. 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. Other states do have laws that at least partially relate to the credit counseling agency. Many of these, however, were written when the industry generated few complaints, and therefore, most of these laws either limit credit counseling to non-profit agencies or provide non-profits with an exemption from mandatory requirements. This exemption is the primary reason why many of the agencies discussed in this Report applied for 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 for contacting and servicing consumers also inhibits effective state enforcement. Many counseling agencies 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. Agencies 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.

There are currently two attempts to draft model legislation for states to adopt. In February 2004, the National Consumer Law Center and the Consumer Federation of America jointly issued a Model Consumer Debt Management Services Act.[159] In March 2004, the National Conference of Commissioners on Uniform State Laws discussed a draft of the Consumer Debt Counseling Act.[160] Both laws would impose much tighter licensing and business practices on all credit counseling agencies.

In many states, the most significant regulatory action has come from suits filed by the attorneys general of various states. In addition to an earlier action brought by the District of Columbia,[161] the Attorneys General in Illinois,[162] Minnesota,[163] Missouri,[164] and Texas[165] have all filed lawsuits against AmeriDebt in 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 operating between Ballenger and their other affiliated CCAs such as DebtServe, to

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[159] Available at *http://www.law.upenn.edu/bll/ulc/UCDC/Feb2004modelbill.pdf.*
[160] Available at *http://www.law.upenn.edu/bll/ulc/UCDC/Mar2004mtgdraft.htm.*
[161] District of Columbia v. AmeriDebt, Inc. and Andris Pukke, Superior Court of the District of Columbia.
[162] State of Illinois v. AmeriDebt, Inc., Circuit Court of the Seventh Judicial Circuit, Sangamon County.
[163] State of Minnesota v. AmeriDebt, Inc., District Court, Fourth Judicial District.
[164] State of Missouri v. AmeriDebt, Inc., Circuit Court of St. Louis City.
[165] State of Texas v. AmeriDebt, Inc., et al., District Court of Travis County, Texas.

whom AmeriDebt now refers all potential DMP enrollees. Nor have the suits impacted the questionable business practices within the Cambridge and Amerix credit counseling conglomerates.

In addition to state enforcement action, AmeriDebt is also facing a number of private lawsuits. Consumers have filed class action lawsuits in Illinois,[166] Alabama,[167] California,[168] and Massachusetts.[169] With the exception of the Massachusetts case, each is limited to the AmeriDebt family of corporations.

D. Federal Regulation and Enforcement

The 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 noted above in Section III(B), 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 501(c)(3).[170] The non-profit status of CCAs arose mainly by historical pattern, rather than any specific decision by Congress. When creditors established the first credit counseling agencies, 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 activities within their borders.

The rapid evolution of the credit counseling industry caught the Internal Revenue Service by surprise. In most areas, Congress has indicated that federal scrutiny of non-profits should be fairly lax: regulators should not deter agencies from fulfilling charitable purposes by imposing standards that are more suitable to the for-profit sector. In most cases this policy preference is appropriate because non-profits are seeking to make a positive contribution to society. In the case of the bad actors in the credit counseling industry, however, certain individuals used this lower standard to enter the industry with an explicit profit motive.

Since the recent problems of the credit counseling industry have surfaced, the IRS has taken several steps to address the issue both retroactively and prospectively. Retroactively, the IRS has initiated audits of fifty CCAs, including nine of the fifteen largest CCAs in terms of gross receipts.[171] The IRS Commissioner has informed the Subcommittee that the Service will

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[166] Cass v. AmeriDebt, Inc., et al., Circuit Court of Cook County, Illinois.
[167] Crawford v. AmeriDebt, Inc., et al., U.S. District Court for the Northern District of Alabama.
[168] Polacsek v. Debticated Consumer Counseling, Inc., et al., U.S. District Court, Central District of California.
[169] Zimmerman v. Cambridge Credit Counseling Corp., et al., U.S. District Court for the District of Massachusetts.
[170] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (11/20/03).
[171] 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.

not hesitate to revoke the 501(c)(3) designation of any CCA that has abused its non-profit status.[172] 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 501(c)(3) organization under the statute. The non-profit can appeal 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 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.[173] The Compliance Team currently has twelve staff members, including technical specialists, examination agents, and attorneys from the Office of Chief Counsel.[174] These individuals review the applications, including budgets and outsourcing contracts, of new CCAs to ensure that they plan to operate as true non-profits.

(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 in or affecting commerce.[175] The FTC, however, lacks jurisdiction 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."[176] 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.[177] Even with these jurisdictional issues to contend with, the FTC has made inroads in enforcing the Federal Trade Commission Act against CCAs who may be abusing their non-profit status.

On November 19, 2003, the FTC filed a complaint against AmeriDebt, DebtWorks, Andris Pukke, and Pamela Pukke, and a second complaint against the Ballenger Group.[178] The 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. The FTC has settled its case against Ballenger, which was based on the same basic premises, but the case against the remaining defendants is still at an early stage. A ruling on the remaining defendants' respective motions to dismiss is expected on May 3, 2004.

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[172] Everson letter, p. 7.
[173] Everson letter, p. 4.
[174] Everson letter, p. 4.
[175] 15 U.S.C. § 45(a).
[176] 15 U.S.C. § 44.
[177] 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).
[178] FTC v. AmeriDebt, Inc., et al., Case No. PJM 03cv3317, United States District Court for the District of Maryland; FTC v. Ballenger Group, LLC, et al., United States District Court for the District of Maryland.

The FTC is currently investigating several CCAs as well as their relationships with various for-profit entities. These investigations have not yet been made public.[179]

(3) Pending Bankruptcy Legislation

Another factor necessitating a more immediate remedy to the problems facing the credit counseling industry is the possibility that Congress will enact the bankruptcy reform bill. The credit counseling provisions in Section 106 of the current bankruptcy bill (H.R. 975) would amend the bankruptcy act 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 also requires that after filing for bankruptcy under either Chapter 7 or Chapter 13, the debtor complete "an instructional course concerning personal financial management."

The bill requires the clerk of each district to maintain a public list of credit counseling agencies and instructional courses approved by the United States Bankruptcy Trustee or the bankruptcy administrator for each bankruptcy district. Agencies and instructional courses would have 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.

[179] Subcommittee briefing by FTC representatives (03/15/04).

The bill also spells out minimum requirements for instructional courses concerning personal financial management. These courses must, among other requirements:

- 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.

Agencies and courses are initially approved for a six-month probationary period and for one-year terms thereafter. "Interested parties" may periodically seek judicial review of these approvals. A district court may also investigate any credit counseling agency and remove it from the list.

VI. FINDINGS AND RECOMMENDATIONS

Based upon the Subcommittee's investigation, the Subcommittee staff recommends that the Subcommittee make the following findings and recommendations.

(1) **Abusive Practices.** Some credit counseling agencies are engaged in abusive practices that hurt debtors, including by charging excessive fees, putting marketing before counseling, and providing debtors with inadequate educational, counseling, and debt management services.

(2) **Profiteering.** Some non-profit credit counseling agencies are funneling millions of dollars each year from cash-strapped debtors to insiders and affiliated for-profit businesses, in apparent violation of tax laws prohibiting tax-exempt charities from benefiting private interests.

(3) **Creditor Standards.** As part of ongoing efforts to halt abusive practices in the credit counseling industry, major creditors should review and strengthen their standards for credit counseling agencies with whom they do business, as well as their methods for monitoring and enforcing compliance. These standards should include requiring credit counseling agency to join an association such as NFCC or AICCCA and to comply with their membership requirements.

(4) **Stronger Enforcement.** The IRS and FTC should accelerate their enforcement efforts to review suspect credit counseling agencies and take appropriate action against agencies and others who are violating restrictions on tax exempt entities or engaging in deceptive or unfair trade practices. Federal enforcement personnel should also consider coordinating their actions with state enforcement agencies to make efficient use of government resources.

(5) **Improved Bankruptcy Bill.** The Senate should consider modifying credit counseling provisions in the pending bankruptcy legislation to strengthen protections against abusive

practices, including determining whether a single authority, the U.S. bankruptcy trustee, should issue a central list of qualifying credit counseling agencies to provide counseling to bankruptcy petitioners and whether credit counseling fee limits would be appropriate.

(6) **New Legislation.** The Senate should consider introducing federal legislation, either modeled on the Debt Repair Organizations Act of 1996 or expanding that law's application to reach non-profit entities, to strengthen protections against abusive practices in the credit counseling industry.