

STATEMENT OF PHILIP A. LEHMAN
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**BEFORE THE U.S. SENATE COMMITTEE ON COMMERCE, SCIENCE AND
TRANSPORTATION**

Hearing on the Debt Settlement Industry: The Consumer's Experience

April 22, 2010

Chairman Rockefeller, Senator Hutchison, and Members of the Committee, my name is Phil Lehman. I am an Assistant Attorney General in the Consumer Protection Division of the North Carolina Department of Justice. I have served in that capacity for 22 years and have specialized in litigation and legislation relating to consumer credit and credit fraud. I appreciate the opportunity to appear before the Committee and to share my experience about consumer protection issues relating to the business of debt settlement.

I. Unfair and Deceptive Practices in the Offering and Performance of Debt Settlement Services are Widespread and are a Major Consumer Protection Problem for State Attorneys General.

Consumer abuses in the marketing and delivery of debt settlement services have been a major consumer protection problem for state attorneys general. The problem is particularly acute in the current economic downturn when many consumers are overwhelmed with debt, are delinquent in credit card payments, and are looking for legitimate ways to cope with their debt burden. Unfortunately, too many of these consumers fall prey to unscrupulous debt settlement businesses that make grandiose offers of debt reduction but deliver little relief. In our experience, most consumers are worse off after enrolling in debt settlement programs. Typically, consumers' debt balances increase with added interest, their payments are diverted to the debt settlement company instead of the creditor, and collection efforts, including legal action, are stepped up against the consumer.

Last October, the National Association of Attorneys General (NAAG) submitted comments on behalf of 41 attorneys general to the Federal Trade Commission in support of the FTC's proposed Rule on Debt Relief Services.¹ The attorneys general noted that unfair and deceptive activity in the debt settlement industry was widespread. Citing the fact that consumer complaints had substantially increased and that attorneys general had filed over 128 enforcement actions against debt relief companies, the comments welcomed the comprehensive regulatory initiative proposed by the FTC:

The States view the eradication of unfair and deceptive practices in the debt relief industry - and the harm caused to consumers and the marketplace by these practices - as a consumer protection priority. . . [The States] submit that the comprehensive bright line approach reflected in the proposed rules would substantially aid law enforcement agencies in addressing the harms that have been caused to consumers by unscrupulous practices in the debt relief industry.

In the comments, the attorneys general described some of the prevailing problematic debt settlement practices based on information obtained from cases and numerous consumer complaints:

- (1) Deceptive solicitations, including unsubstantiated claims of consumer savings and the length of time required to complete the program. (see sample solicitations attached as Exhibit 1)
- (2) Failing to adequately inform consumers that collection efforts, including lawsuits, will continue against them due to the extended nonpayment of consumers' accounts while in the debt settlement program and that the consumer's credit standing will deteriorate. (Sample solicitation: "You'll avoid bankruptcy, put an

¹ FTC Notice of Proposed Rulemaking to amend the Telemarketing Sales Rule to address the sale of debt relief services, 74 Fed. Reg. 41988 (Aug. 19, 2009). The comments submitted by NAAG are available at <http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00192.pdf>

end to harassing phone calls from creditors, and allow your credit score to dramatically improve.”)

- (3) Failing to adequately inform consumers that before debts are settled, the balances on their credit accounts will increase significantly due to accumulating interest and late charges. (Default rates on credit card accounts can be as high as 30%, so a consumer’s \$10,000 debt could rise to \$13,000 after one year of nonpayment.)
- (4) Lack of adequate screening and individual budget analysis to determine whether a debt settlement program is suited for the consumer.
- (5) Deceptive disparagement of consumer credit counseling services and bankruptcy, which are often more effective alternatives for the consumer.
- (6) The collection of substantial advance fees before any meaningful services are rendered, so that the debt settlement company profits even if the consumer receives no benefits. (Fees typically range from 15% to 18% of the consumer’s debt, and are collected in the earlier months of the program before settlements are concluded.)
- (7) Advising consumers to cease payments on their credit accounts and to cease communications with their creditors.
- (8) Failing to provide regular information to consumers about collection of fees, status of debt settlement accounts, and communications with creditors.

The consumer protection problems in the area of debt relief services are not limited to a few bad actors; they are pervasive throughout the industry. The whole premise of debt settlement is based on consumers not paying their debts and not communicating with creditors,

i.e., essentially encouraging breach of contract. The theory is that the older and more delinquent the debt, the easier it will be to negotiate. Only after sufficient funds are accumulated in the consumer's settlement account (after deduction of fees), which can take a year or more, the debt settler may initiate some settlement negotiation activity. Consumers are taking a big risk, while interest charges mount and the debt settler's fees are being collected, that they will eventually get relief from all their debts.

During the extended period of time while consumers are making payments to their debt settlement accounts, problems are likely to arise. Creditors have not agreed to any debt relief plan, they are not receiving any payments, and they are blocked from offering debt resolution options directly to their customers. These months of nonpayment and non-communication lead not only to increased debt, but also to increased collection efforts and legal action.

Further, a significant portion of the consumer's initial payments is diverted to the settlement company's fees.² If the consumer drops out before the settlement process is concluded, as is usually the case, he or she will lose the fee payments, while facing increased debt account balances.³ The debt settler therefore profits whether or not it accomplishes anything for its client.

Because of these rampant consumer abuses in the debt relief industry, 41 attorneys

² Attached is a copy of a payment schedule offered to a North Carolina consumer by Heritage Debt Relief in December 2009. It calls for the payment by the consumer of \$6,906 in fees to Heritage. The consumer has to make monthly payments of \$575 for an unspecified period of time. The consumer's first five monthly payments of \$575 are allocated entirely for Heritage's fees, followed by half (\$287.74) of the next 14 months payments.

³ A study published by the Colorado Attorney General's Office based on annual reports submitted by debt settlement companies from 2006 through 2008 revealed that only 7.8% of consumers who began debt settlement programs in 2006 had completed them by the end of 2008. 53.3% of consumers had dropped out of the programs. The Colorado information came from licensed debt settlement providers, not outlaws or "bad apples." See Comments of the Colorado Attorney General on the FTC's proposed debt relief amendments to the Telemarketing Sales Rule, <http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00189.pdf> In a lawsuit brought against debt settler National Asset Services (NAS), the Florida Attorney General alleged that over a six-year period, only 13.5% of Florida residents had completed NAS' debt settlement program. In a similar case brought against NAS, the New York Attorney General alleged that out of 1,981 New Yorkers enrolled in the NAS program, only about 3% completed it.

general specifically support the FTC's proposal to prohibit debt settlement companies from collecting advance fees. The advance fee ban, while opposed by much (but not all) of the debt relief industry, is the key to preventing fraud and ensuring that debt settlement services will be performed. There is precedent for such an advance fee prohibition, particularly for suspect services that purport to help distressed debtors. The federal Credit Repair Organizations Act, 15 U.S.C. § 1679b(b), and many similar state laws prohibit credit repair businesses from charging fees until all promised services are fully performed. Similarly, the Telemarketing Sales Rule, 16 C.F.R. § 310.4(a)(4), prohibits advance fees for loan brokering services, another business activity characterized by deceptive promises and minimal performance. Many states prohibit advance fees for foreclosure relief and mortgage loan modification services because of widespread consumer fraud in the offering and delivery of those services. The FTC is also recommending an advance fee prohibition in its proposed Rule on Mortgage Assistance Relief Services (75 Fed. Reg. 10707, March 9, 2010).

II. North Carolina Law Prohibits Debt Settlement Services if Advance Fees Are Charged.

Debt relief services are not a new phenomenon, nor are the consumer abuses associated with such services. Over 40 years ago, at least 13 states, including North Carolina, enacted "debt adjusting" or "debt pooling" statutes not just to regulate, but to prohibit, the then-prevailing model of debt settlement. In fact, North Carolina and the other similar state statutes made debt adjusting a criminal offense. The 1963 preamble to the North Carolina statute, N.C. Gen. Stat. § 14-423, *et seq.*, explained the reasons for banning debt adjusting services, reasons which are still very pertinent today:

. . . these [debt adjusting] practices have grown to such proportions that for the most part

they have become a national menace by preying upon unfortunate people and harassed debtors, and those engaged in such practices, except for a few, have engaged in false advertising, have falsely held themselves out as competent and able to solve debt problems regardless of any and all circumstances, have lured ignorant and unsuspecting people into executing contracts heavily loaded in their favor and have charged large fees for alleged services which results in piling debt upon debt.⁴

In 1963, the U.S. Supreme Court upheld the constitutionality of a similar Kansas debt adjusting statute in a case brought by the Kansas Attorney General against a company known as “Credit Advisors.” The Court held that the prohibitory statute did not violate due process rights and noted the State’s evidence that the business of debt adjusting “lends itself to grave abuses against distressed debtors.” Ferguson v. Skrupa, 372 U.S. 726.

The original definition of debt adjusting in the North Carolina and similar statutes covered debt settlement activities but applied only where the debt adjuster received funds from the consumer to distribute to the consumer’s creditors. To get around the statutes, debt settlers in recent years arranged for third party bank accounts to receive the consumer’s funds. By this method, the debt settlement company did not hold consumers’ money but could still direct the disbursement of funds to pay its fees and to pay creditors if and when settlements were reached.

In 2005, the North Carolina General Assembly, recognizing the abuses perpetrated by the new breed of debt settlers, amended the debt adjusting statute to simply prohibit advance fees for any debt settlement or foreclosure assistance services, whether or not the debt settler directly managed and disbursed consumer funds. The amendments have created a bright line test for compliance and have been effective enforcement tools. The 2005 amendments do not prevent debt settlement companies from operating in North Carolina as long as no fees are charged prior to completion of settlements. The Attorney General’s Office is aware of at least two national

⁴ 1963 N.C. Session Laws, Chap. 394

debt settlement companies currently doing business in North Carolina without charging advance fees.

Licensed North Carolina attorneys are generally exempt from the debt adjusting statute but unfortunately, some attorneys have run their law firms as debt settlement businesses with some of the worst deceptive practices in the industry. Two of the North Carolina Attorney General's litigated enforcement cases have been against out-of-state law firms who defrauded consumers by diverting funds out of client settlement accounts. One continuing area of concern is the practice by some debt settlement companies to use attorneys as fronts to offer their services in states that have restrictive debt settlement laws. A debt settlement company will arrange for an out-of-state law firm to contract with a North Carolina resident. The law firm then assigns all of the accounting and debt negotiation work back to the debt settlement firm. To claim an exemption from the debt adjusting law, the law firm may associate a local North Carolina attorney to represent the client in name only.

III. Consumers Need Effective Debt Management Assistance.

There is clearly a need for legitimate, effective debt relief for consumers who cannot pay off their credit card accounts and do not want to file for bankruptcy. However, the current model of debt settlement is not the answer. Most debt-strapped consumers can benefit from financial counseling, budgeting, and debt management services offered by nonprofit consumer credit counseling agencies. These agencies offer debt management plans that allow for the orderly reduction of debt under a payment plan agreed to by both the consumer and the creditor. Fees are nominal and monthly payments are paid promptly to creditors, not held back for 12 months or more as with debt settlement. While in the plan, the consumer gets protection from collection

contacts.

One of the problems with current debt management programs is that they do not offer significant principal reduction. The logical next step, which would benefit both consumers and the banking industry, would be a combination of a multi-year payment plan followed by forgiveness of principal after successful completion of the payment plan. Principal reduction is now being incorporated into mortgage loan modification programs. Unfortunately, accounting rules relating to debt charge-offs have prevented principal reduction programs from being implemented. A coalition of bankers, consumer groups and credit counseling services have approached the Office of the Comptroller of Currency (OCC) to authorize these programs but the OCC has not been receptive to date.

IV. Conclusion

The debt settlement industry has been characterized by deceptive solicitations, over-promising of results, underperformance of services, and excessive fees. Too often, debt settlement companies have profited off of economically distressed consumers while delivering little relief in return. My colleagues in other attorneys general offices and I appreciate the attention the Committee is giving this important consumer protection problem.

Exhibit 1 – Sample Debt Settlement Solicitations



Are You Eligible?

Please use the Credit Relief Act Tool provided below, to see if you are among the Thousands of North Carolina Residents who qualifies for the Credit Relief Program! Debt Reductions vary based on Criteria and current Hardship Status...

- HOME
- INFORMATION
- ELIGIBILITY
- MEDIA
- RESOURCES
- FAQS
- PROGRAM

INSTRUCTIONS

- Fill out the Form to the Right and answer the Three Questions, and find out if your Eligible for the State of North Carolina Credit Relief Program granting credit relief to North Carolina Residents.
- If you meet the eligibility requirements you will receive a security pin number with directions on how to access your Credit Relief Informational Package, please write down your Secure PIN Number for future reference.
- If your criteria does not match the necessary requirements you will be prompted to an explanation page for details of ineligibility.



- *Must be a Current North Carolina Resident
- *Must be over the Age of 18
- *Must be suffering from a Financial Hardship

Input Information Below...

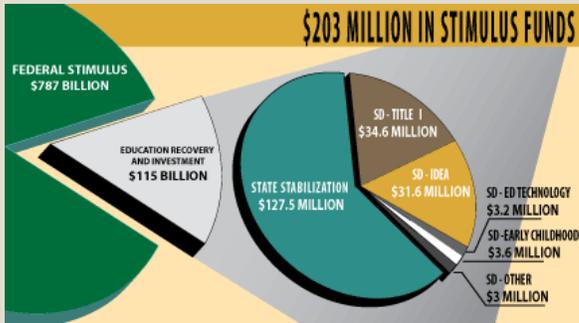
What is your approximate Unsecured Debt amount?

How many dependents did you claim on your 2008 NorthCarolina State Tax Return?

Are You Experiencing Financial Hardship? Yes No

**By clicking below, you certify the above criteria is met and you have answered the questions truthfully and accurately.

[Find out if you are eligible](#)



HOME | INFORMATION | ELIGIBILITY | MEDIA | RESOURCES | FAQS | PROGRAM | PRIVACY POLICY | 800.965.3620



www.ssa.gov | www.ftc.gov | www.USA.gov | www.FinancialStability.gov

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Revolving Credit - Payment Reduction		CODE US1	
a. ID Number [REDACTED]	b. Debt Reduction Hotline 1-800-481-5922	Account Type: REVOLVING - CONSUMER	
c. ECONOMIC STIMULUS ACT 213 EXECUTIVE PARK ASHEVILLE, NC 28801		Notice Type: 009-S	Subject: NOTIFICATION
d. Addressee's Personal ID Number ST110888	State SC	RE: HR5140 Economic Stimulus Act of 2008	
e. Number, address, and Zip code [REDACTED]		BUY OUT PROGRAM	ISSUER: PROGRAM DIRECTOR
		ESTIMATED TOTAL DEBT* \$25,000	

Form **009-S** Payment Reduction Notification

2009

FORM 009
BALANCE REDUCTION NOTIFICATION
PLEASE READ ENTIRE DOCUMENT CAREFULLY

Dear [REDACTED]

Your Revolving Consumer Debt and Credit Card Payments are eligible for debt settlement programs created in response to the Governmental Economic Stimulus Act of 2008.

These new programs enable the Debt Service Center to reduce your existing consumer debt of **\$25,000** and receive a significantly reduced monthly payment, without the traditional restrictions on credit, income, or employment status.

If you have experienced financial hardship, have late payments, or would like to significantly reduce your monthly payments, call **1-800-481-5922**. When calling please reference file number **ST110888**.

YOU MAY BE ELIGIBLE FOR DEBT RELIEF UP TO

\$12,500

HR5140 Economic Stimulus Act of 2008 was designed to provide economic stimulus through recovery rebates to individuals, incentive for business investment, and increase in conforming and loan limits. This Act became Public Law No: 110-185 on February 13, 2008. HR 5140 information is available to anyone at: www.govtrack.us/congress/bill.xpd?bill=h110-5140.

Call U.S. Debt Relief:

1-800-481-5922

(press option 1)

Monday-Friday 9:00-9:00 EST. Saturday 11:00-4:00 EST.



This product or service has not been approved or endorsed by any government agency and this offer is not being made by an agency of the government. This is not a promise to lend. Rates and terms are subject to change. *Existing consumer debt and settlement amounts are estimated and may vary based on individual situations.

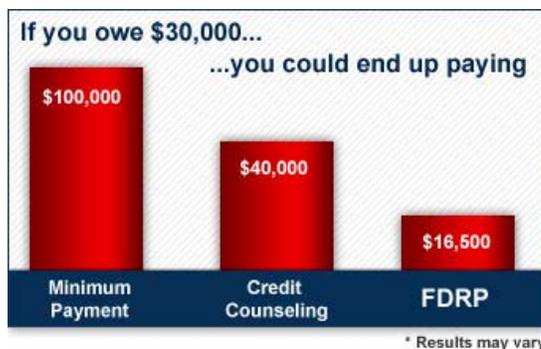
Federal Debt Relief Program

Federal Debt Relief Program has arrived. We offer the fastest and least expensive way to eliminate debt. Federal Debt Relief Program is an effective alternative to bankruptcy. If your credit cards, medical bills or personal loans have become overwhelming, we can reduce your debt so you can pay it off fast and be back on the road to financial freedom. Get a free savings quote today!

With Federal Debt Relief Program, you can be debt free in 24 – 48 months, plus:

- Reduce your debt by up to 50%
- Get one low monthly payment
- Eliminate harassing phone calls
- Avoid bankruptcy

Millions of American individuals and families today are drowning in debt. It doesn't have to be this way. Debt relief is available right here, right now. It's yours for the asking. Federal Debt Relief Program can negotiate on your behalf with your creditors to obtain the highest amount of debt elimination possible for you. Federal Debt Relief Program can help you regain your financial freedom and make personal debt a thing of the past. Get a free savings quote today!



Help With Medical Bills • Credit Card Debt Elimination Service • Debt Relief Grant • Tax Debt Relief
Credit Card Debt Relief Counseling • Credit Card Debt Relief Program • Federal Debt Relief Program

LEGAL

Federal Debt Relief Program is not a government program or government related program. Estimates based on prior results and cannot be guaranteed; individual results will vary based on circumstances. Settlement percentages exclude program fees. We do not guarantee that your debts will be reduced by a specific amount or percentage or that you will be debt-free within a specific period of time. We do not make monthly payments to creditors, assume consumer debt, provide tax, bankruptcy, accounting or legal advice or credit repair services.

* First Name: * Last Name:

* Primary Phone: - - Secondary Phone: - -

This must be a valid, working phone number!

* Email Address: * Select your State: Please Select

* Amount of Debt: \$30,000 - \$39,999

Questions/Comments:

START GETTING OUT OF DEBT!

Exhibit 2 – Sample Debt Settlement Fee Schedule

Terms of Agreement

13. SERVICE FEES. Heritage Debt Relief charges a flat 10% service fee for all services provided.			
TOTAL SERVICE FEE:	\$6,906.00	PAYMENT SCHEDULE:	
Payment Schedule: 1 st payment	\$575.50	Due on:	1/28/2010
Payment Schedule: 2 nd payment	\$575.50	Due on:	2/28/2010
Payment Schedule: 3 rd payment	\$575.50	Due on:	3/28/2010
Payment Schedule: 4th payment(if applicable)	\$575.50	Due on:	4/28/2010
Payment Schedule: 5th payment(if applicable)	\$575.50	Due on:	5/28/2010
Payment Schedule: Remaining Service Fee	14 Payments of \$287.74	Beginning on:	6/28/2010

"HDR earns its fees as follows: 1/3 of the total fee is earned when HDR performs budget review, debt analysis and file setup. The second 1/3 of the total service fee is earned when HDR has prepared initial correspondence to the contracted creditors. The final 1/3 of the total fee is earned when HDR has received notification from CLIENT to begin settlement of the contracted accounts."

14. **Discharge or Withdrawal.** Either party may discharge the other by written notice when received by the discharged party. CLIENT will be obligated to pay COMPANY that portion of the service fees earned by COMPANY according to the attached payment schedule.

This written AGREEMENT constitutes the full and complete agreement between CLIENT and COMPANY and supersedes any and all other agreements or understandings whether written or oral. CLIENT verifies by signing below that CLIENT has read and understands the AGREEMENT and has been provided a copy for personal records.

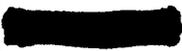
CLIENT WILL BE OBLIGATED TO PAY COMPANY THAT PORTION OF TOTAL FEES ALREADY EARNED IN ACCORDANCE WITH PARAGRAPH 13 OF THIS AGREEMENT.

NOTICE

YOU THE BUYER MAY CANCEL THIS AGREEMENT AT ANY TIME BEFORE MIDNIGHT OF THE THIRD DAY AFTER THE DATE OF THE TRANSACTION. SEE ATTACHED NOTICE OF CANCELLATION FOR AN EXPLANATION OF THIS RIGHT.

THIS WRITTEN AGREEMENT constitutes the full and complete AGREEMENT between CLIENT and Heritage Debt Relief. This written AGREEMENT supersedes any and all other agreements or understands, whether written or oral for the matter described in Paragraph 2.

I VERIFY THAT I HAVE READ AND UNDERSTAND THE ABOVE AGREEMENT AND THE ABOVE NOTICE. I ALSO VERIFY THAT I HAVE BEEN PROVIDED WITH A COPY FOR MY PERSONAL RECORDS.

PRINT NAME 	SIGN X	DATE
PRINT COSIGNER NAME (if applicable)	SIGN X	DATE