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United States Senate

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Committee on Governmental Affairs

Norm Coleman, Chairman

Carl Levin, Ranking Minority Member

BUSINESS & LABOR

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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



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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

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>.

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

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.

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.

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).

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,

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.