AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

Strange Bedfellows: Bankruptcy Reform and Mandatory Credit Counseling

Written by:
Leslie E. Linfield
Institute for Financial Literacy
Portland, Maine
llinfield@financiallit.org

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[1] (Reform) mandates pre-filing credit and budget counseling for consumers seeking bankruptcy protection under both chapters 7 and 13. This provision has remained consistent throughout the bill's many versions, with minor changes to clarify the language and intent. Given the longstanding animosity between consumer bankruptcy counsel and the credit counseling industry, the impact and implications of mandatory credit counseling on consumer bankruptcy practice deserve attention.

Debtor Redefined by the New Law

Leslie E. Linfield

Section 106 of the Reform states that "an individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing the petition by such individual, received from an approved nonprofit budget and credit counseling agency...an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assist such individual in performing a related budget analysis."[2]

This presents new challenges for clients, who now face an additional hurdle prior to seeking the protections afforded in bankruptcy. The accessibility of such counseling has been questioned in some quarters, and others have expressed concern that this new federal mandate is unfunded and passes on another cost to an already insolvent debtor. Finally, there is concern that the budget analysis completed during the mandatory counseling session may be based on principles different than those of the means testing, and hence that a debtor could be "misled about their opportunities for relief under the Code."[3]

Counsel also faces new challenges presented by this provision. First, there is the perceived competition between consumer bankruptcy attorneys and the credit counseling agencies (CCAs), which administer debt-management plans (DMPs). Debtor's counsel will be forced to refer clients to these very same CCAs for the mandatory pre-filing credit counseling. Additionally, counsel may find themselves confronted with situations surrounding the mandatory counseling, which may place them in ethically compromising positions.

Costs of Counseling

The Reform does not address who should pay the cost of this mandatory counseling and therefore has been presumed to be an unfunded mandate on the client. The Reform does require that "if a fee is charged for counseling services, [CCAs] charge a reasonable fee and provide services without regard to ability to pay the fees."[4]

The Joint Committee on Taxation (JCT) has also addressed credit counseling fees in its report entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*.[5] This report, which makes numerous reform recommendations for the nonprofit credit counseling industry, recommends requiring a CCA "to have a fee policy that any fee that may be charged must be reasonable in relation to the services provided."[6]

"Reasonable" is the clear standard. However, it has not been defined by the Reform, the JCT or the IRS. The Reform directs the U.S. Trustee (or Bankruptcy Administrator) to approve nonprofit budget and credit counseling agencies, and perhaps that office will define and regulate a "reasonable" counseling fee as part of the approval process.

In the meantime, perhaps we can look to the credit counseling industry itself for guidance. In a letter to Rep. James Sensenbrenner (R-Wis.), Susan Keating, president and CEO of the National Foundation for Credit Counseling (NFCC), wrote: "There will be costs associated with counseling...the bill requires that those fees be 'reasonable.' Some NFCC member agencies charge or request a contribution for counseling (the average amount is $15)..."[7]

Availability of Counseling

Clients must obtain credit counseling within the 180-day period preceding the filing of their petition. The Reform presumes that a debtor is able to obtain counseling from an approved nonprofit budget and credit counseling agency within five days of their initial request.[8]

According to the *Best Practices Guidelines* published by the Association of Independent Consumer Credit Counseling Agencies (AICCCA), current industry standards call for CCAs to offer an appointment within two business days of a request.[9]

Exceptions to Counseling Requirement

"[A] debtor who resides in a district for which the U.S. Trustee (or the bankruptcy administrator, if any) determines that the approved nonprofit budget and credit counseling agencies for such district are not reasonably able to provide adequate services"[10] may be exempt from the mandatory credit counseling requirements under the Reform. However, the advancements in Internet and telephone credit counseling

1 All references are to S. 256, 109th Cong., 1st Sess. (2005).
2 S. 256, §106(a).
3 *See* Bermant, Gordon and Flynn, Ed, "Planning for Change: Credit Counseling at the Threshold of Bankruptcy," 20 *ABI Journal* 1 (February 2001).
4 S. 256, §111(c)(2)(B).
5 *Options to Improve Tax Compliance and Reform Tax Expenditures*, 2005 JCS-02-05.
6 *Id.* at 334.
7 Letter from Susan C. Keating, president and CEO of the National Foundation for Credit Counseling, to Hon. **F. James Sensenbrenner Jr.**, Chairman, Committee on the Judiciary (March 15, 2005).
8 S. 256, §106(3)(A)(ii).
9 Available at www.aiccca.com/images/bestprac.pdf.
10 S. 256, §106(a)(2)(A).

seemingly make it difficult for the Executive Office of the U.S. Trustee (EOUST) to deem a district not served or underserved. Most credit counseling at this point is provided via telephone rather than a face-to-face meeting.

The Reform measure does allow the court to waive the counseling requirement based on "exigent circumstances."[11] One such exigent circumstance that may fall within such an exemption is a client seeking protection from imminent foreclosure on the family home under chapter 13.

Budget Analysis

The Reform requires that a client be assisted in performing a "related budget analysis"[12] in addition to being counseled on "the opportunities for available credit counseling."[13] Though currently there are no rules in place to define what such a "related budget analysis" will entail under Reform, traditional credit counseling compares available net income against monthly living expenses, and then determines what excess is available for debt repayment.

There has been much discussion about the impact of means testing on debtors under the new law. Interestingly, an analysis comparing CCA clients enrolled in a DMP and their prospective outcomes in chapter 13 under the means testing as proposed by the Reform was conducted in 2000.

In an *ABI Journal* article published in February 2001, **Gordon Bermant** and **Ed Flynn** analyzed more than 5,000 DMP clients. They found across the board "that the guidelines and rules of thumb now used by CCA to determine their clients' expenses and disposable incomes were not developed on the basis of the IRS expense guidelines...."[14] They further concluded that most CCA clients would have fared better under means testing, and that their chapter 13 budgets would have allowed for a better quality of life compared to the budgets crafted by the CCAs.

Bermant, who recently reviewed the newest language of the Reform, said, "The work we did earlier [in 2001] would suggest that they would be better going into bankruptcy, and nothing in the new legislation would change my opinion." The final conclusion raises some interesting issues for clients and counsel alike:

> What the data presented here show, we believe, is that would-be debtors in bankruptcy should be informed during the mandatory credit counseling, *at the very least,* that expense allowances (hence budgets and disposable incomes) in bankruptcy may be based on different principles than those the CCA will use for its own purposes.[15]

Competition?

There would seem to be a natural tension between credit counseling and the consumer bankruptcy bar, as one might argue they compete for each other's clients. Some consumer bankruptcy attorneys have expressed concern about the impact that sending their clients to CCAs for counseling will have on their practice.

The following example is a clear demonstration of this competitive mentality. On a large national CCA's web site, there is a link entitled "bankruptcy assistance" under the list of services offered. The text of that page includes the following: "Our debt-management plan has helped thousands of people stay out of bankruptcy. Best of all, our experienced and well-trained counselors will design a repayment plan that you can handle. And unlike bankruptcy, we'll show you how to stay out of debt and rebuild your financial future."[16]

This web site leads a potential client seeking more information about bankruptcy to a FAQ page, where the following Q&A is found:

> **Q.** *When should I consider bankruptcy?*
>
> **A.** Taking drastic financial measures such as bankruptcy is never an easy decision. The impact it has on you emotionally and financially can be devastating, not to mention the toll it takes on your credit. Let a [CCA name] counselor help you with this decision. Chances are, bankruptcy is not your only alternative. We're available by phone, Internet or local office.[17]

Another potential pitfall for counsel will be CCAs that offer client referral fees to attorneys. This approach was demonstrated by a nonprofit CCA in 2003 when bankruptcy reform's passage looked like a reality. The organization, known as Family Credit Counseling Corporation (FCCC), was advertising an "enrollment broker program"[18] for attorneys.

The following are excerpts taken directly from a series of e-mail correspondence between FCCC and a Massachusetts licensed attorney in March 2003:

> **FCCC:** This is a very simple yet lucrative service you could provide to your clients through FCCC... Most industry leaders such as Consolidated Credit Counseling Services or AmeriDebt do not offer a broker program allowing proper professionals to actively enroll clients into a program, but rather offer some miniscule referral fee as compensation.
>
> **Atty.:** Could we start off with a definition of the broker relationship? Would I be referring clients to you and taking a referral fee, or would I be directly employed?
>
> **FCCC:** The broker program is not set up under a referral basis...but rather as a consulting basis...after providing potential clients with an analysis of their debts...you as an enrollment broker can then charge that client a consulting fee...industry standards resemble a one-time $199, $299, or even a sum that is equal to the client's monthly payment.
>
> **Atty.:** Do you do bankruptcy work?
>
> **FCCC:** I'm sure you are aware, as I stated before, there are many proposed changes in bankruptcy legislation right now...interpretations are that individuals are required to receive a briefing from a credit counseling agency...however, (sic) the law is passed, this is a simple yet lucrative service any agency such as yours could incorporate into their everyday services with little to no overhead.

The above raises concerns, most particularly in the area of professional conduct and ethics. Peter Geraghty, of the ABA Center for Professional Responsibility, says that "state and local bar association ethics opinions are divided on this issue" of attorneys receiving a referral fee. An example of such conflict can be demonstrated by two ethics opinions. A joint opinion issued by the Philadelphia and Pennsylvania Bar Associations allows attorneys to accept referral fees under certain conditions:

> The Rules permit a lawyer to accept a referral fee from a service provider, provided that the lawyer is scrupulous in determining under the particular circumstances that payment of the referral fee will not impact the lawyer/client relationship or the lawyer's exercise of independent professional judgment and the client consents after full disclosure and consultation.[19]

In comparison, an opinion issued by the Supreme Court of Ohio found that "this Board advises that it is ethically improper for a lawyer to accept a fee from a financial-

11 S. 256, §106 (a)(3)(A)(i).
12 *Id.*
13 S. 256, §106(3)(A)(ii).
14 *See supra* note 3.
15 *Id.*
16 Available at www.credit.org/bankruptcy_assistance.htm.
17 Available at www.credit.org/faq_bkassistance.htm.
18 This program is still advertised as of March 26, 2005, on their web site at www.familycredithelp.org/broker.html.
19 *See* Joint Formal Opinion of the Philadelphia and Pennsylvania Bar Associations Opinion 2000-100 (2000).

services group for referring clients in need of financial services."[20]

The conflicting legal ethics opinions may become moot if the JCT proposals are brought before Congress, specifically the recommendation dealing with referral fees. The JCT would prohibit both 501(c)(3) and (c)(4) organizations from receiving or paying fees for leads. A CCA would have to operate under the following requirement: "It receives no compensation for providing referrals to others for services to be provided to consumers, and pays no compensation to others for obtaining referrals of consumers."[21] This change, if enacted, would eliminate potential referral programs.

Attorney-run CCA?

At this point, debtors' counsel may wonder if they shouldn't just form their own nonprofit budget and credit counseling agency. David Falvey of Action Advocacy in Connecticut may have some words of wisdom to share. Falvey, who runs a full-time consumer bankruptcy practice, also organized a nonprofit CCA in 1997 because he had an "interest in exploring and experimenting with this DMP thing and because the light bulb went off that this (DMP) was nothing more than an informal chapter 13."

Falvey quickly found out how difficult it was to run a CCA. He applied for tax-exempt status as a 501(c)(3), which he described as a "tedious process." Next he went through ISO certification so that he could seek membership in AICCCA and became licensed by the state's banking department. Although he could have been exempt from licensing as an attorney, he quickly discovered that creditors wouldn't deal with him as a nonprofit unless he was licensed. Finally, he points out that he must have the CCA's books independently audited annually, which is costly.

Maurice Selinger, a partner with Curtis Thaxter Stevens Broder & Micoleau LLC in Portland, Maine, specializes in tax-exempt organizations and nonprofit law. Selinger thought that an attorney trying to form a nonprofit organization for the purposes of providing their clients with the mandatory credit counseling would run into several issues. The primary issue would be a lack of exempt purpose. The primary purpose for the organization would be to get the client through a statutory "hoop" so they could pay the attorney legal fees for representation in the bankruptcy proceeding.

Selinger identified the heightened scrutiny of the credit counseling industry as another issue. Any application for tax-exempt status would most likely come under greater scrutiny by the IRS, and exemption probably would not be granted before the Reform's enactment.

When asked if he would organize a CCA today, Falvey's response was interesting. He felt that bankruptcy attorneys should be allowed to offer the full spectrum of financial counseling because attorneys follow the Cannon of Ethics. His CCA, which may be the smallest documented one in the country with a DMP portfolio of approximately 70 clients, showed a loss of $1,365 in 2003 and has a fund balance of only $977. A review of previous years shows similar results. It would appear Falvey has had more interest in the DMP "experiment" rather than any profit motive.

Falvey intends to seek approval from the U.S. Trustee as a nonprofit budget and credit counseling agency under Reform. He may be the only bankruptcy attorney out there with two entrances to his office—one for mandatory credit counseling and a separate one for bankruptcy representation.

Clearly, the mandated consumer credit counseling requirements will pose challenges for both clients and counsel. Clients will need to understand what to expect of the counseling process and that they may need to bear the additional cost in order to access the bankruptcy system. Counsel will now need to interface with an industry they have traditionally been adversarial with, and at the same time remain vigilant for schemes that may place them in ethically compromising positions. If it is axiomatic that politics (and by extension, legislation) make strange bedfellows, it will be interesting to see how this shotgun wedding of the consumer bankruptcy bar and the credit counseling industry fares. ■

Reprinted with permission from the ABI Journal, *Vol. XXIV, No. 4, May 2005.*

The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 10,500 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.

[20] Board of Commissioners on Grievances and Discipline of the Supreme Court of Ohio Opinion 2000-1 (2/11/00).

[21] *See* note 5 at p 332.