Appeals Court Decision Opens Door to More Credit Repair Class Action Litigation against Credit Counseling Agencies

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The United States Court of Appeals for the First Circuit recently found in *Zimmerman v. Puccio* that a tax-exempt, nonprofit credit counseling agency operated as a "credit repair organization" within the meaning of the Credit Repair Organizations Act ("CROA"), 15 U.S.C. §§ 1679-1679j, and that certain principals of the organization were personally liable under CROA. *Zimmerman v. Puccio*, No. 09-1416 (1st Cir. 2010).

The *Zimmerman* decision adopts a sweeping interpretation of CROA that equates credit counseling agencies with credit repair organizations. As a result, we are likely to see an increase in credit repair class action lawsuits, which can be crippling to nonprofit credit counseling agencies, especially those that offer or provide services to renegotiate, settle, reduce, or otherwise alter the terms of consumer debts.

Background

Under CROA, a credit repair organization is defined as any person, including an attorney, who uses interstate commerce or the mail to sell or provide services for the express or implied purpose of improving any consumer's credit history. 15 U.S.C. § 1679a(3). CROA prohibits a number of acts and practices, including: misrepresentations of services a credit repair organization can provide, 15 U.S.C. § 1679b(a)(3); and engaging in or attempting to commit a fraud or deception on any person in connection with the services of a credit repair organization, *Id.* § 1679b(a)(4), among others. Credit repair organizations may not receive payments before any promised service is fully performed. Such services must performed under a written contract that is accompanied with a separate disclosure statement. CROA can be enforced by the Federal Trade Commission ("FTC"), state Attorneys General, and by private plaintiffs in court (including as class actions). Consumers can sue to recover the greater of the amount paid or actual damages, punitive damages, costs, and attorney's fees for violations of CROA.

In 2001, Andrew and Kelly Zimmerman, husband and wife, enrolled in a debt management plan ("DMP") with Cambridge Credit Counseling Corporation, a tax-exempt nonprofit credit counseling agency, after learning about Cambridge through radio, television and Internet advertisements. In 2003, the Zimmermans accused Cambridge Credit Counseling Corporation, its founders John and Richard Puccio, and several other affiliated corporate entities of violating CROA, a statute which generally regulates those offering "credit repair" services, especially "credit repair organizations," as well as the state consumer protection law.

The district court initially granted the defendants' motion to dismiss the Zimmermans' federal claims, finding that, as a nonprofit entity, the credit counseling agency was exempt from CROA. On appeal of that judgment, the First Circuit Court vacated the district court's dismissal of the plaintiffs' federal claims and remanded the case for reconsideration. *Zimmerman v. Cambridge Credit Counseling Corp.,* 409 F.3d 473 (1st Cir. 2005). The First Circuit concluded that the statutory exception to CROA liability for "any nonprofit organization which is exempt from taxation under section 501(c)(3)" of the Internal Revenue Code, 15 U.S.C. § 1679(a)(3)(B)(i), did not apply to the defendants simply because they had been recognized by the Internal Revenue Service as being exempt from federal income taxation under section 501(c)(3) entities. *Zimmerman*, 409 F.3d at 475-77. Instead, the First Circuit held that in order to qualify for the statutory exemption, an entity "must actually operate as a nonprofit organization and be exempt from taxation under section 501(c)(3) [of the Internal Revenue Code]." *Id.* at 478 (emphasis in original). As a result, the First Circuit ruling was reading far more into the statute than Congress had intended, potentially requiring credit

counseling agencies to prove in court that they were, in fact, operating as nonprofit organizations.

After the First Circuit's remand, the case went back to the district court. This time, the district court certified an entire class of DMP customers, giving the Zimmermans plenty of company at the plaintiff's table in this class action. For almost two years, the parties conducted discovery, which concluded with both parties filing cross motions for summary judgment. In January 2008, the district court considered these opposing motions and granted summary judgment for the plaintiffs.

In granting summary judgment for the plaintiffs - the opposite of its ruling in 2004 - the court found that the credit counseling agency and various other corporate defendants, including a back-office processor and marketing company operated by the Puccios, operated as credit repair organizations within the meaning of CROA because they "crossed the boundary from credit counseling into credit repair with their continued and insistent representations to consumers that their services could only help improve clients' credit." *Zimmerman*, 529 F. Supp. 2d 254 at 275 (D. Mass. 2008). The court held that the credit counseling agency, which has since settled the case with the plaintiffs and remains tax exempt, was not exempt under CROA's provision for nonprofit organizations because it did not, at the time of the transactions with the plaintiffs, "in fact and as a matter of law, operate as a nonprofit." *Id.* at 277.

The district court determined that, as credit repair organizations, the credit counseling agency and corporate defendants had not complied with any of CROA's requirements. *Id.* at 278. Specifically, they did not provide consumers with a required disclosure statement, did not include certain required items in their service agreements, and did not give consumers a separate mandatory cancellation form along with the service agreement. *Id.* at 278-79. Additionally, the district court found that the defendants violated CROA by charging up-front fees to consumers before they had fully performed the promised services. *Id.* at 279.

In addition, with regard to the provisions of CROA directed not just at credit repair organizations but at "any person," the court found that the Puccios and the corporate defendants were liable for "mak[ing] or us[ing] . . . misleading representation[s] of the services of [a] credit repair organization" under 15 U.S.C. § 1679b(a)(3) and for "engag[ing] . . . [in a] course of business that constitutes or results in . . . an attempt to commit…a fraud or deception on any person in connection with the offer or sale of the services of the credit repair organization" under 15 U.S.C. § 1679b(a)(4). *Id.* at 279-80. As examples, the court found that the corporate defendants made misleading representations to clients that they would be retaining a nonprofit credit counseling agency when, in fact, their accounts were transferred to a for-profit corporation. The district court entered a final judgment against the Puccios, awarding damages to the plaintiffs on behalf of the certified class, in the amount of $256,527,000, which reflected only compensatory damages; rather than punitive damages, which are then trebled under CROA.

Appeal and First Circuit Decision

The Puccios appealed the grant of summary judgment; the remaining corporate defendants did not appeal. The Puccios based their appeal on the argument that they did not fall within the ambit of CROA because their credit counseling enterprise was not a "credit repair organization" as defined by the statute. They also argued that the district court erred in piercing the corporate veil when it found them liable for engaging in fraud under Section 1679b(a)(4). Finally, in their primary argument directed at their substantive liability under Section 1679b(a)(3), the Puccios argued that the district court did not, in fact, find them liable under the "misleading representation" provision, *Id.* § 1679b(a)(3). Alternatively, if the district court did find them liable under (a)(3), the Puccios argued that the district court again erred in piercing the corporate veil.

The First Circuit affirmed the district court's grant of summary judgment to the plaintiffs, concluding that "credit counseling aimed at improving future creditworthy behavior is the quintessential credit repair service." In doing so, it rejected *Hillis v. Equifax Consumer Servs., Inc.*, 237 F.R.D. 491 (N.D. Ga. 2006). In *Hillis*, the district court (located in the 11th Circuit) drew a distinction between purporting to repair or retroactively fix past credit problems and purporting to improve credit in the future, and because the definition of credit repair organization refers to services whose purpose is to improve a consumer's credit record, credit history, or credit rating, CROA's requirements applicable to credit repair organizations did not apply to services that offer "only prospective credit advice to consumers or provide information to consumers so that they can take steps to improve their credit in the future." *Id.* at 514.

The First Circuit in *Zimmerman* considered the *Hillis* distinction and found it "unsupportable." Instead, the First Circuit quoted the district court in stating,

> [t]he ostensibly forward-looking orientation" of representations about improving clients' credit "does not mitigate the obvious message to debtors

> that [those] services might modify the effect of their past credit history on their credit score.

(emphasis in original). As a result, the First Circuit determined that:

> Credit records are constantly changing based on the ongoing performance of the consumer. By improving credit behavior prospectively, a consumer aims to improve a pre-existing credit record, credit history, and/or credit rating with a more favorable record, history, or rating in the future.

Further, the First Circuit dismissed the defendants' attempts to escape liability under CROA by inserting a disclaimer in the DMP contract that the "client's credit rating was outside the scope of [the] Agreement." Instead, the court found in the record numerous examples of Cambridge repeatedly holding itself out as a company that would provide "advice and assistance" in order to "improv[e] any consumer's credit record, credit history, or credit rating," which are "squarely covered by CROA."

Finding that several of the other corporate defendants also were credit repair organizations, the First Circuit affirmed the district court's finding of liability for the Puccios under Section 1679b(a)(3) as a result of their misleading consumers into thinking they were doing business with a nonprofit corporation, when, in fact, their accounts were being wholly serviced by a for-profit company. The First Circuit recognized that it was piercing the corporate veil, but it found that the undisputed evidence showed that the Puccios owned and had "pervasive control" over all of the entities involved in this litigation. The First Circuit did not reach the question of "fraud or deception" in connection with the offer or sale of the services of a credit repair organization. 15 U.S.C. § 1679b(a)(4).

Implications

Many companies advertise and market their personal financial advisory services as having some relationship to a consumer's credit record, credit history, or credit rating. *Zimmerman* calls into question *Hillis* and other cases that stand for a narrow reading of the definition of a credit repair organization and the distinction between purporting to repair or retroactively fix past credit problems (being credit repair) and purporting to improve credit in the future (not being credit repair). Further, *Zimmerman* raises the potential that virtually all services to contact clients' creditors to try to "negotiate 're-aging' of accounts, a process designed to improve credit scores by relabeling delinquent accounts as current" constitute credit repair activities that fall under CROA. As the First Circuit observed, "credit counseling aimed at improving future creditworthy behavior is the quintessential credit repair service."

The First Circuit appears to leave scant room for credit counseling agencies that provide DMPs to consumers to fit outside of the scope of CROA. Moreover, in this line of cases, there already had been a decision that adopts a two-part test for *bona fide* tax-exempt nonprofit credit counseling agencies, requiring such agencies to: (1) be recognized by the IRS as being exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code; and (2) actually operate as a *bona fide* nonprofit organization. As a result, the First Circuit requires that a nonprofit that might otherwise be covered by CROA satisfy this two-part test in order to be exempt from the statute.

Put simply, the door is now wide open for class action lawsuits targeting credit counseling agencies – regardless of tax-exempt or nonprofit status – based on nothing more than the agencies' provision of DMP plans (that are incidental to the education and counseling provided by the agencies). In other words, a plaintiff can make such an allegation against a *bona fide* tax-exempt, nonprofit credit counseling agency and then the agency must prove not only that the IRS has recognized its 501(c)(3) status, but that it is actually operating as a *bona fide* nonprofit organization if it wishes to be deemed exempt from CROA's requirements.

In short, credit counseling agencies need to determine whether they can and should comply with CROA's requirements, or whether they intend to rely on the nonprofit exemption. The latter can be an extremely costly (even if insurance coverage would be available), damaging decision, even if ultimately successful. While the FTC and state Attorneys General may not be lining up to bring CROA enforcement actions against *bona fide* nonprofit organizations, the plaintiff's bar likely will be, especially because the per-client penalties for CROA violations are so high, and because they can recover their legal fees if successful.

While this case was poorly defended and involved egregious facts of alleged wrongdoing that bear no resemblance to the operations of present-day legitimate credit counseling agencies, including those of Cambridge itself, the court took a broad view of the definition of a credit repair organization and, as a result, the scope of CROA. Credit counseling agencies now face the unexpected challenge of an interpretation that brings them within the scope of a statute that was intended to

apply to services completely unrelated to credit counseling.

The ruling heightens the risk, particularly for credit counseling agencies doing business in the First Circuit (encompassing Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island), that their activities, especially their DMPs and less-than-full balance repayment programs, may trigger coverage under CROA and give rise to class action litigation, forcing them – at great expense – to prove that they are actually operating as *bona fide* nonprofit organizations (in order to be exempt from CROA, particularly for what has transpired in the past), or, alternatively, to comply with CROA's requirements prospectively. Of course, unfortunately, complying with CROA's requirements going forward will provide no protection for what happened in the past.

Despite a stated exemption for tax-exempt, nonprofit organizations in CROA, the broad interpretation of the statute adopted by the First Circuit may, unfortunately, lead to a wave of litigation against legitimate nonprofit credit counseling agencies that provide invaluable assistance to consumers in financial distress.

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