National Consumer Law Center
Fighting Together for Economic Justice

Why Debt Settlement is Bad for People in Debt:

It doesn't work. It hurts people in debt. And it hurts businesses too.

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Debt settlement companies claim they can negotiate reduced payoffs on consumer credit card bills and similar debts. They convince consumers to stop paying their bills if they haven't already done so. But debt settlement can leave people worse off than when they started.

Debt settlement doesn't work:

- Most customers can't settle all their debts,[1] so the unsettled ones end up even bigger.
- A high percentage of customers drop out of debt settlement agreements.[2]
- Most major credit card companies won't deal with debt settlement companies.[3]

Debt settlement hurts people in debt:

- Signing up increases debt collection calls and lawsuits because debt settlement companies encourage participants to default on their debts.
- Participants' credit scores plummet 161 points on average within 6 months after joining, and take years to recover. In comparison, bankruptcy and credit counseling often cause credit scores to go up.[4]
- Some debt settlement companies convince customers to sign high-rate consolidation loans.[5]
- Debt settlement companies charge people hefty fees for getting the same settlement the creditor would offer directly.
- Debt settlement companies' fees take up a big chunk of the money the debtor is setting aside.[6]

- Participants can end-up worse off than when they started.
    - The debts that don't settle get bigger
    - Participants owe big fees on the settled debts + related fees + taxes on settled debts + legal fees or judgments from being sued.

Debt settlement hurts businesses:

- Debt settlement is estimated to drive about half of all defaults.[7]
- An estimated three-quarters of accounts were current when the customer signed up for debt settlement.[8]

Consumers have better, less harmful options

There are three better options than debt settlement:

- **Nonprofit credit counseling:** Credit counselors give advice for free or a nominal fee and, if appropriate, set up a debt management plan under which they distribute monthly payments to participating creditors. The creditors agree to stop collection efforts and waive or reduce penalties, late fees, and interest in return for installment payments that will pay all of the original principal balance.
- **Chapter 13 bankruptcy:** Chapter 13 is like debt settlement in that debtors pay a reduced percentage of the balance due. But it is court-supervised and creditors must participate and stop all collection efforts.
- **Chapter 7 bankruptcy:** Chapter 7 typically eliminates the same debts that consumers enroll in debt settlement, but the benefits are more certain and quicker.

Summary Comparison of Debt Settlement, Debt Management Plans, and Bankruptcy

	Debt Settlement	Nonprofit Debt Management Plan	Bankruptcy
Debt reduction method	Negotiate partial payment of debts	100% payment of principal, fees waived, interest reduced	**Ch 7:** typically 0% payment **Ch 13:** Partial payment
Can it address secured debt?	No	No	Yes
Does it affect all creditors?	No	No	Yes
Does it stop debt collection harassment?	No	Yes[9]	Yes

	Debt Settlement	Nonprofit Debt Management Plan	Bankruptcy
Can customer predict in advance which creditors will participate?	No	Yes[10]	Yes
Are total fees predictable at beginning?	No	Yes	Yes
Is the net benefit (reduction of debt after fees) predictable at the outset?	No	Yes	Yes[11]
What is the impact on credit scores?	Big immediate drop, followed by slow rise; average score 30pts better after 72m[12]	Slight drop followed by slow rise[13]	Except in the unusual case where the debtor is current on all debts at the time of filing bankruptcy, filing bankruptcy results in: **Ch. 7:** Big immediate score increase, followed by slow rise; average score 116pts better after 72m **Ch. 13:** Steady rise; average score 85pts better after 72m[14]
Does the cancellation of debt trigger potential tax liability?	Yes	No	No

Many states have laws on the books that protect consumers by banning debt settlement or limiting how much they may charge. Lawmakers should push back against any attempts to weaken those laws. With economic pressures and inflation at an all-time high, people in debt need real solutions, not debt settlement traps.

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Endnotes

1. Will S. Dobbie, Financial outcomes for debt settlement programs: Estimates for 2011-2020 (Jan. 15, 2021) (industry study showing only 23% of customers *completing* the program settle all debts). The industry does not report the number of customers who drop out), https://aa4dr.org/reports/.

2. *See, e.g.*, Prelim. Rpt. of Temp. Receiver, CFPB v. Stratfs, LLC, No. l:24-cv-00040-EAW-MJR at 36 (W.D.N.Y. Jan. 31, 2024) (70% drop-out rate); State of Colo., 2014 Annual Report-Colorado Debt-Management Services Providers (registered debt settlement companies reported the following percentage of completed agreements--2014: .43%, 2013: 2.28%, 2012: 4.93%, 2011: 13.18%, 2010: 20.98%). In re Kinderknecht, 470 B.R. 149, 159 (Bankr. D. Kan. 2012), objections overruled sub nom. Parks v. Persels & Assocs., LLC, 509 B.R. 345 (D. Kan. 2014) (operating as Care One) (68% drop-out rate).

3. CFPB, The Consumer Credit Card Market, at 143 (Sept. 2021) ("Most issuers maintain a policy of not working directly with DSCs"), https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2021.pdf.

4. Frederic Huynh (Freedom Debt Relief), Debt Settlement and Bankruptcy: A Comparison of Credit Scores at 12 (July 2022) (median FICO Score of Ch. 7 filers was up 89 points one year after bankruptcy; Ch. 13 filers were up 25 points; debt settlement customers were down 161 points after six months). The study did not provide a median score for debt settlement customers at one year, but a chart shows their median score was still below their starting score at that point. *Id.* at 17.

5. FinRegLab, Debt Resolution Options: Market & Policy Context at 32 (Oct. 2022) (noting rates of 22 to 25% before origination fees).

6. *Id.* (citing study showing "the typical settlement amount is approximately 50 percent of the balance owed at settlement, but that fees to the [debt settlement company] reduce the total savings to roughly 30 percent of the balance owed."). Note that the balance at settlement will be larger than the starting balance because of late fees and interest.

7. FinRegLab at 33.

8. Debt Settlement Consumer Impacts, Presentation to Consumer Lending and Debt Collection Subcomm. of CFPB Consumer Advisory Comm., at 7 (11/30/22), on file with NCLC

9. Only for creditors that participate.

10. This is predictable because creditors agree in advance with nonprofits to participate in debt management plans. So, when a credit counselor meets with a consumer, the roster of participating creditors is already known.

11. Creditors have the right to dispute the dischargeability of debts and the amount they will receive in a chapter 13 plan, but such challenges are not common.

12. Huynh at 9.

13. NFCC® Sharpen Your Financial Focus Initiative Impact Evaluation, Fig. A2 (study included people receiving only credit counseling and those in debt management plans) (2016)

14. Huynh at 9.