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COVER STORY

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Prisoners of Debt

The fresh start promised by bankruptcy is under attack as big lenders keep squeezing money out of consumers whose debts were canceled by the courts



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In a financial version of *Night of the Living Dead*, debts forgiven by bankruptcy courts are springing back to life to haunt consumers. Fueling these miniature horror stories is an unlikely market in which seemingly extinguished debts are avidly bought and sold.

The case of Van Rathavongsa illustrates how canceled debts regain vitality. The Raleigh (N.C.) factory worker pulled himself out from beneath a mountain of bills by means of a bankruptcy proceeding that wrapped up in 2002. One of the debts the judge canceled, or "discharged," was \$9,523 Rathavongsa owed to Capital One Financial ([COF](#)), the big credit-card company. But Capital One continued to report the factory worker's discharged debt to credit bureaus as a live balance, according to documents filed in U.S. Bankruptcy Court in Raleigh.

This kind of failure by creditors to update credit reports happens with some frequency, consumer lawyers and court-employed bankruptcy trustees say. And it can have consequences: In September, 2003, when Rathavongsa tried to close on a \$274,650 mortgage for a new house, his would-be lender, Wachovia ([WB](#)), said he would either have to pay Capital One or show proof from the credit-card company that the debt had been discharged. Despite several calls and a letter from his attorney, he says, Capital One never revised the credit report. To obtain the home loan, Rathavongsa eventually did what many consumers in this situation do. He gave in and paid Capital One \$9,523 he no longer legally owed.

'HAPPENS ALL THE TIME, YOUR HONOR'

Because of episodes like this, discharged debts have attracted the attention of little-known firms expert at buying and selling a range of delinquent consumer obligations. Back-due bills with a face value of billions of dollars change hands at a steep discount every year. Five of the companies in this business are publicly traded on Nasdaq. Others have large private-money backers. B-Line, in Seattle, was acquired last year by the Dallas-based hedge fund firm Lone Star Funds. The investment bank Bear Stearns ([BSC](#)) owns two bankruptcy-debt buyers: Max Recovery and eCast Settlement.

The very existence of this marketplace confounds even some veterans in the bankruptcy field. During a preliminary hearing in New York in March, U.S. Bankruptcy Judge Robert Drain asked a lawyer for JPMorgan Chase ([JPM](#)) how the bank had managed to sell consumer credit-card debts that had been discharged. "I don't know who would buy a discharged account," the perplexed judge said.

"Happens all the time, your honor," the Chase lawyer, Thomas E. Stagg, responded.

Drain's confusion is understandable. Traditionally, discharged debt was seen as not worth the paper it's written on. Once a judge excuses some of a debtor's obligations—part of the bankruptcy system's goal of granting a financial fresh start—that person has no legal duty to pay them. In fact, bankruptcy law prohibits efforts to collect discharged debt.

In the 1990s, businesses adept at tracking and trading consumer debt expanded their reach to dabble in accounts enmeshed in bankruptcy. That dabbling has grown into a robust market. Some of the trade in so-called bankruptcy paper involves debts that remain collectible. What's troubling is that the market now also includes billions in discharged debts, which ought to have no dollar value. Owners of canceled liabilities can revive their value in two main ways: by directly pressuring consumers to cough up cash or by gaming the credit system, as allegedly happened in the Rathavongsa case.

`CAVALIER ATTITUDE'

The Raleigh man filed a motion in bankruptcy court in November, 2003, asserting that Capital One had improperly failed to update his credit report. U.S. Bankruptcy Judge A. Thomas Small agreed. Capital One, Small wrote in December, 2003, "most likely received notice" of Rathavongsa's bankruptcy filing, as indicated by the company's having ceased trying to collect the debt. Because Capital One never responded to Rathavongsa's motion, the judge wrote, "the court can assume that Capital One filed the erroneous credit report for the purpose of pressuring Rathavongsa to pay a discharged debt." In February, 2004, the judge ordered the company to repay the \$9,523, as well as \$14,000 in fines and attorney's fees for its "cavalier attitude toward the debtor's motion."

A Capital One spokeswoman, Tatiana Stead, says: "Our records show we did not receive proper notice regarding the bankruptcy notice or subsequent discharge of Mr. Rathavongsa's account." The company has paid what the judge ordered "to put an end to the matter and avoid the additional expenditure of resources that would have been required to appeal the judge's ruling," she says.

Consumer lawyers and even some longtime players in the bankruptcy-paper market say they're worried that the trading of canceled debt encourages unsavory efforts to collect on discharged debt. "What you are highlighting is a significant abuse in the industry," acknowledges William Weinstein, a former chief executive of B-Line and a pioneer in the debt-buying business. Speaking generally and not about his former company, he confirms that some lenders and debt buyers simply hound consumers to pay debts that have been canceled, while others refrain from informing consumer credit bureaus when debts are eliminated. "The failure to accurately update credit reporting has allowed unscrupulous activity to prosper," says Weinstein. He left B-Line last year after it was purchased by Lone Star for an undisclosed sum, a departure marked by now-settled litigation between Weinstein and his former company. B-Line's current president, Rui Pinto-Cardoso, says the firm doesn't engage in the practices Weinstein describes.

`AN ALLEGED TRAP' FOR DEBTORS

The pair of plaintiffs whose case in New York came before Judge Drain in March alleged they had been hurt by credit reports that hadn't been brought up to date. Yvette R. Torres and Ariadna Mateo had owed Chase a total of \$7,674 on three credit-card accounts. Those debts were discharged years earlier during proceedings under Chapter 7 of the U.S. Bankruptcy Code. Torres and Mateo sued Chase because the three accounts continued to appear on their credit reports, as if they were live. According to a hearing transcript, the judge said he was suspicious about why Chase hadn't updated the reports when it received routine court notices of the discharges. Chase, the judge speculated, might have been trying to use the incorrect credit reports as a way to pressure the debtors to pay off the discharged debt. Further, the judge said, "the only reason Chase could sell it is because someone believed they could collect on it."

On May 3, Judge Drain denied Chase's motion to dismiss the central claim by Torres and Mateo. "The essence of the plaintiffs' allegations is that Chase has continued to lay a trap for them until the eventual day that they need an accurate credit report," the judge said in a written ruling. "Such behavior, if proven at trial, would be sufficiently vexatious and oppressive to support at least sanctions in the amount of plaintiffs' costs and expenses incurred in releasing the trap." A trial date hasn't been set.

Denying any infraction, Chase has said in court papers that it didn't try to collect debts improperly and that it had no legal duty to update the credit reports. In a prepared statement, Chase spokeswoman Tanya Madison adds that the lender generally "does not attempt to collect a debt once we learn that the account is included in a bankruptcy filing." Chase notifies credit bureaus that an account is "subject to a bankruptcy" within 60 days of the lender learning of a bankruptcy filing, Madison says. She declines to comment on Chase's sale of discharged debts or on any suit.

Other judges warn that the secondary market in bankruptcy paper is encouraging improper collection tactics, which increase the potential value of that debt. William R. Sawyer, a U.S. bankruptcy judge in Montgomery, Ala., says that in the past two years he has seen a surge in cases alleging that lenders and debt buyers have purposefully neglected to report the discharge of debt to credit bureaus. The ploy, he says, is an "indirect means" of pushing consumers to pay debts they no longer really owe. "Creditors and collectors are skating as close as they can to the law and really trying to diminish its value."

AN INDUSTRY TRANSFORMED

There aren't any reliable statistics to document this development, however, and the legal parameters remain murky. Since 1986 the staff of the Federal Trade Commission has issued a series of formal "opinion letters" saying that the credit bureaus should report when debts have been discharged. Clarke W. Brinkerhoff, an FTC staff attorney who wrote two of the letters, says that in the view of the commission, creditors must inform credit bureaus that the discharged accounts have a zero balance. But that obligation doesn't appear in any statute.

Ambiguities abound. Bankruptcy judges are divided on whether a lender's failure to update a credit report can be considered an improper attempt to collect. The Fair Credit Reporting Act requires credit bureaus to ensure "maximum possible accuracy" of their reports, but the bureaus are allowed to rely on lenders to provide debt information. "These laws were not written for the way this industry has been transformed," says Ronald J. Mann, a law professor at Columbia University. Nevertheless, Representative Jerrold Nadler (D-N.Y.), a member of the House Judiciary Committee, says the Justice Dept. should investigate whether creditors and debt buyers are trying to collect discharged debts. "Documented abuses have largely gone unpunished," he says.

Belinda Hedge knows more about bankruptcy law than the average non-lawyer from working as a debt collector for a student loan firm. She filed for protection from creditors in November, 2005, in part, she says, because a friend-turned-identity-thief opened credit-card accounts in Hedge's name and ran up \$12,079 in bills. In March, 2006, most of her debts, including two credit-card accounts with Capital One totaling \$2,414, were discharged by the U.S. bankruptcy court in Knoxville, Tenn. "Once you file, they're supposed to cease all contact," says Hedge.

But last year, Capital One and two debt collectors it hired tried more than 140 times by phone and mail to collect on one of the discharged accounts, according to letters and a phone log the 41-year-old Hedge kept. She sent the company and its collectors court records from her bankruptcy, but the calls continued. Collectors have called her mother and brother 10 times and threatened to contact her employer and garnish her wages, Hedge says. Stead, the Capital One spokeswoman, attributes the collection attempts to the lender's failure to update Hedge's credit report to reflect the discharge, and says that it is correcting the error. Capital One doesn't "conduct direct collection efforts [on] accounts after they have been discharged," she adds.

SPREADING MISBEHAVIOR

Hedge's experience isn't unusual, says Brian Budsberg, a Tacoma (Wash.) U.S. bankruptcy trustee, a court official who oversees bankruptcy cases. Budsberg says his impression is that the number of debtors alleging collection abuse "is greater than it has ever been." Trustees elsewhere agree. Lately, Budsberg says, he has observed "an emboldened attitude by the collection arms of credit-card companies and debt buyers."

The market in discharged debt has its roots in the early 1990s, when lenders began to seek at least minimal returns from overdue consumer accounts. The stale debts included those of customers who had filed under Chapter 7, saying they couldn't pay their bills, and those who filed under Chapter 13, a provision allowing individuals with some resources to set up schedules to pay creditors. Creditors are notified by the court when a consumer files bankruptcy, and again when a discharge is granted.

Some lawyers and bankers saw a business opportunity in the bulk acquisition of bankrupt paper. "It was a new niche. Banks didn't understand what it was worth," says Charles Rusbasan, a former executive with Chemical Bank before it acquired Chase and adopted the Chase name. Rusbasan approached Bear Stearns in 1992 to finance a debt-buying operation, and that led to the birth of Max Recovery. Today he is CEO of Max Recovery, which is in London, and its sister, eCast Settlement in New York. He is also a senior managing director at Bear Stearns.

Rusbasan says that the keys to success in this esoteric field are buying debt very inexpensively—it can sell for a fraction of a cent on the dollar—and employing proprietary software to track debts as they move through the bankruptcy process. He plays down his companies' trading in debt discharged under Chapter 7, saying most of his business has focused on Chapter 13 debt, which is supposed to be repaid. Bear Stearns doesn't break out the financial results of its debt-buying units, but filings by publicly traded debt buyers show they are highly profitable. Norfolk (Va.)-based Portfolio Recovery Associates ([PRAA](#)) earned \$44 million in 2006 on \$188 million in revenue, a margin of 23%. Portfolio Recovery said in its 2006 annual report that it had paid \$55 million to buy debts with a face value of \$6.3 billion that had gone into bankruptcies since 2004. (It didn't distinguish between Chapter 7 and Chapter 13 cases.)

Rusbasan says that sales of Chapter 7 debt are growing. One large bank, which he won't name, is planning a bulk sale of Chapter 7 debt this fall with a face value of \$3 billion, he says. He expects similar mass sales later this year and next.

B-Line's former CEO, Weinstein, who started the company in 1997, takes credit for helping build the market for

Chapter 7 debt. Even debt initially designated as discharged can bring legitimate returns, he says. In some cases, bankruptcy courts discover that Chapter 7 debtors have additional assets, which are then divided among creditors. Other Chapter 7 cases are moved to Chapter 13 or dismissed altogether, making debts potentially collectible. In a tiny fraction of cases, people repay discharged debts out of a sense of moral duty.

Increased competition recently in the bankruptcy-paper market has driven up the price of discharged debt—from 1/20th of a cent on the dollar to 3/20ths, or higher—and that has helped spur more aggressive collection tactics, Weinstein says. He says he hasn't participated in any improper conduct.

SECOND THOUGHTS

Raymond P. Bell Jr. sees worrisome efforts to collect on discharged debts from his perch as vice-president of the bankruptcy and probate division of Creditors Interchange in Abington, Pa. His unit collects on a variety of bankruptcy paper for banks and debt buyers, clients Bell won't name. A veteran of 43 years in the field, he agrees that intensifying competition has led some "cowboys" to try to collect on discharged debts. In early 2005, an analysis of several hundred accounts from one client showed that 85% had been discharged in bankruptcy. Rather than try to squeeze money from those accounts, Bell says he dropped the client.

One company that plays a middle-man role in the bankruptcy-paper market has had second thoughts. Online marketplace CreditMax, based in West Palm Beach, Fla., says it has brokered more than \$1.2 billion in bad loans. That includes 25 to 30 bulk sales of Chapter 7 credit-card debt, each with \$1 million to \$10 million of face value, to two major buyers. But in response to questions from *BusinessWeek*, CreditMax said on Aug. 21 that it would stop selling Chapter 7 debt. In an e-mail, company founder Stephen Kass called the move "socially responsible," without further explanation.

There's no evidence of a rush to imitate CreditMax. A rival, DebtConnection.com, posted on June 20 an offer to sell a batch of Chapter 7 bankruptcy accounts with a face value of \$200 million. The sale was on behalf of Collect America, one of the nation's largest debt buyers and collectors. The posting said the bankruptcy cases had an average filing date of April, 2006. Most Chapter 7 cases are resolved within about six months, which means many of the accounts would have been discharged by the time they were sold into the secondary market. John Curry, a senior vice-president at Collect America, declines to discuss the June 20 sale. But discharged debts, he says, are finding eager purchasers. "There are companies—that is all they buy," he says. Manny Newburger, a name partner with Austin (Tex.) law firm Barron, Newburger, Sinsley & Weir, which represents Collect America, says that his client isn't aware of abuse by buyers of such debts.

But at the same law firm, another attorney for lenders and debt buyers frets that the heating up of the bankruptcy-paper market portends misuse of tools like the credit report. "There is a sense that people are using it as a weapon," says Barbara M. Barron, the firm's managing member. After Chapter 7 cases, "debtors expect their credit is going to become pristine," she notes. "But now you have people who buy the debts, even bankruptcy debts, and all of a sudden, new people are supplying information to the credit bureaus." She adds: "The way the system is working now, it doesn't give [debtors] that fresh start."

SOLD AND THEN RESOLD

The case of John Pfister, in which Barron Newburger has no role, provides one illustration. Pfister, 63, a retired AT&T (I) technical supervisor in Denton, Tex., received a Chapter 7 discharge in 2001. Then, last January, while applying for a mortgage, he learned that two discharged credit-card debts, a Discover Card balance of \$6,306 and a former Chase account for \$2,683, were showing up on his credit reports. Lenders turned him away because of what appeared to be unpaid obligations, he says.

The Chase loan has been sold twice and is now owned by a debt buyer called Pinnacle Credit Services, according to Pfister's reports from credit bureaus TransUnion and Experian. Pinnacle reported to those credit bureaus as recently as May—six years after the bankruptcy discharge—that the debt is still subject to collection. In addition, Pinnacle has given the former Chase debt a new account number. Pfister's lawyer, James J. Manchee, says that creating a new account number is a strategy some debt buyers use to make it more difficult to tie accounts back to discharged debts, and therefore make the debts appear collectible. Pinnacle declined to comment. In June, Quicken Loans became the 12th mortgage lender to reject Pfister.

Exacerbating Pfister's frustration, collectors for Discover were still leaning on him as recently as late August, despite his having faxed them a copy of his bankruptcy papers. On Sept. 20, he sued Discover in U.S. Bankruptcy Court in Dallas. Contacted by *BusinessWeek*, a Discover spokeswoman blamed the collection attempts on administrative error and said Pfister's credit report has now been corrected. She declined to discuss the lawsuit.

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