IN THE CIRCUIT COURT OF COOK COUNTY
ILLINOIS COUNTY DEPARTMENT, CHANCERY DIVISION

Michael Cass and Derek Huggins, individually and as the representatives of a class of similarly-situated persons,	)	
Plaintiffs,	)	
v.	)	**No. 01 CH 20350**
	)	**Judge Quinn**
AmeriDebt, Inc., DebtWorks, Inc., Infinity Resources Group, Inc., Debticated Consumer Counseling, Inc., The Ballenger Group, L.L.C., Ballenger Holdings, L.L.C., Andris Pukke, and Eriks Pukke,	)	
Defendants.	)	

INTERVENER FEDERAL TRADE COMMISSION'S REPLY IN SUPPORT OF ITS MOTION FOR RECONSIDERATION OF ORDER PRELIMINARILY APPROVING STIPULATION OF SETTLEMENT AND RELEASE AND CLASS NOTICE

Intervener Federal Trade Commission ("Commission" or "FTC") submits this memorandum in support of its motion for reconsideration of the Order Preliminarily Approving Stipulation of Settlement and Release and Class Notice ("Preliminary Approval Order"), and in reply to the response briefs submitted by Plaintiffs and Defendants. As discussed below, the proposed settlement should not proceed at all because defendant AmeriDebt, an integral part of the settlement, has now filed for bankruptcy relief, and the proposed settlement and this case are subject to the automatic stay of the Bankruptcy Code. Only if the Court determines that this case is not stayed can it consider the proposed settlement, in which event the proposed settlement should not be approved because it is clearly inadequate for consumers, and the parties' responses

do nothing to change this fact. Indeed, Plaintiffs' Response demonstrates that they have not adequately represented the proposed class, but rather have agreed to a paltry settlement without conducting meaningful discovery or negotiations. Accordingly, the Court should stay this case, or reject the proposed settlement.

I. AmeriDebt's Bankruptcy Filing and the Automatic Stay of the Bankruptcy Code Prohibit Continuation of the Proposed Settlement

AmeriDebt, Inc. ("AmeriDebt"), a central player in Defendants' scheme to defraud consumers and a party to the proposed settlement, voluntarily filed for bankruptcy relief on June 5, 2004.[1] The continuation of this action against AmeriDebt was stayed immediately upon the commencement of its bankruptcy case. *International Business Machines v. Fernstrom Storage & Van Co. (In re Fernstrom Storage & Van Co.)*, 938 F.2d 731, 735 (7th Cir. 1991); *Martin-Trigona v. Champion Federal Sav. & Loan Ass'n.*, 892 F.2d 575, 577 (7th Cir. 1989); *Holtkamp v. Littlefield (In re Holtkamp)*, 669 F.2d 505, 507 (7th Cir. 1982); *In re Comdisco Sec. Litig.*, 166 F. Supp. 1260, 1261 n.1 (N.D. Ill. 2001); 11 U.S.C. § 362(a).[2] Apparently, AmeriDebt

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[1]AmeriDebt filed its voluntary petition for relief under the reorganization provisions of Chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the District of Maryland, Case No. 04-23649-PM. AmeriDebt remains in possession and management of its assets and business as a debtor-in-possession. 11 U.S.C. §§ 1107, 1108.

[2]Section 362(a) of the Bankruptcy Code provides that, except as provided in Section 362(b), the filing of a bankruptcy petition "operates as a stay" of, among other things:

> (1) the commencement or continuation . . . of a judicial . . . or other action or proceeding against the debtor that was . . . commenced before the commencement of the [bankruptcy] case . . ., or to recover a claim against the debtor that arose before the commencement of the [bankruptcy] case; . . .
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate; . . . [and]

recognizes this fact – it did not join in the Defendants' Response, although there was no explanation as to why.[3]

Moreover, the automatic stay of the Bankruptcy Code prevents the proposed settlement from going forward at all. "[T]he primary use of the automatic stay is to prevent the debtor's estate from being picked to pieces by creditors." *Underwood v. Hilliard (In re Rimsat, Ltd.)*, 98 F.3d 956, 961 (7th Cir. 1996). Thus, the stay prevents "a chaotic and uncontrolled scramble for the debtor's assets in a variety of uncoordinated proceedings in different courts." *Holtkamp v. Littlefield (In re Holtkamp)*, 669 F.2d 505, 508 (7th Cir. 1982) (internal quotations and citations omitted). In addition, the stay ensures that claims are paid in the bankruptcy case in accordance with the priorities of the Bankruptcy Code. *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004).

The proposed settlement violates the stay for numerous reasons. First, it is the continuation of an action against AmeriDebt, as a party to the proposed settlement, and imposes joint and several liability upon AmeriDebt for claims that arose prior to its bankruptcy case, in direct contravention of the clear language of Section 362(a)(1) of the Bankruptcy Code. Settlement Agreement at ¶ 22; 11 U.S.C. § 362(a)(1). Second, it constitutes an "act to collect,

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> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the [bankruptcy] case. . . .

11 U.S.C. § 362(a). None of the exceptions set forth in Section 362(b) applies to this case.

[3]Contrary to the bankruptcy court's local rules, to date, AmeriDebt has failed to file a notice in this case or otherwise advise the Court of its pending bankruptcy case and that the Bankruptcy Code prohibits the continuation of this action against it. *See* Bankr. D. Md. Local Rule 2072-1. Ironically, on or about June 7, 2004, AmeriDebt did file notices of bankruptcy in the FTC and state actions pending against it, even though these law enforcement actions – unlike this action – are not stayed by the bankruptcy filing. *See* 11 U.S.C. § 362(b)(4) (permitting government law enforcement and regulatory actions against the debtor to proceed).

assess, or recover a claim against the debtor that arose before the commencement of" AmeriDebt's bankruptcy case, in violation of the stay contained in Section 362(a)(6) of the Bankruptcy Code. 11 U.S.C. § 362(a)(6). The proposed settlement also circumvents the bankruptcy court's exclusive jurisdiction over AmeriDebt's property necessary to satisfy this obligation. 28 U.S.C. § 1334(e); 28 U.S.C. § 157(a). In this regard, AmeriDebt's schedules of assets and liabilities filed in its bankruptcy case reflect that AmeriDebt is reserving $730,021.72 in a Global Settlement Account in connection with the settlement, as confirmed by AmeriDebt's principals who testified on its behalf at the meeting of creditors held in the bankruptcy case on July 12, 2004. (AmeriDebt's Schedule B – Personal Property, Ex. 1 at ¶ 2). Third, the proposed settlement permits the almost 500,000 class members to recover claims outside of AmeriDebt's bankruptcy case and prior to the bankruptcy court's confirmation of a plan required to deal with the claims of all of AmeriDebt's creditors in the manner required by the Bankruptcy Code. *Official Committee of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 302 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988) ("The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved."). Lastly, it approves the release of claims and effectively grants AmeriDebt a discharge without the burden of obtaining confirmation by the bankruptcy court of a plan that complies with the requirements of the Bankruptcy Code. 11 U.S.C. § 1141(d) ("the confirmation of a plan . . . discharges the debtor from any debt that arose before the date of such confirmation").

Clearly, by attempting to go forward with the settlement, the Defendants have violated the automatic stay. *In re Braught*, 307 B.R. 399, 404 (Bankr. S.D.N.Y. 2004) (plaintiff violated

the stay by not taking action to vacate a judgment entered after the defendant's bankruptcy filing). *See also Middle Tennessee News Co. v. Charnel of Cincinnati, Inc.*, 250 F.3d 1077, 1082 (7th Cir. 2001) ("Actions taken in violation of an automatic stay ordinarily are void"). The only way that Defendants can proceed in this court with the proposed settlement is to seek and obtain relief from the stay. *See, e.g., Helms v. Bridges (In re Bridges)*, 1993 WL 98666, at *6 (Bankr. N.D. Ill. 1993); *In re Alberto*, 119 B.R. 985, 994 (Bankr. N.D. Ill.), *reconsideration denied*, 121 B.R. 527 (Bankr. N.D. Ill. 1990). Moreover, Defendants must file such a motion in AmeriDebt's bankruptcy case because only the bankruptcy court has jurisdiction to grant that relief. *See, e.g., In re Benalcazar*, 283 B.R. 514, 521-22 (Bankr. N.D. Ill. 2002) (citations omitted). *See also* 11 U.S.C. § 362(d); 28 U.S.C. § 157(b)(2)(G). To obtain such relief, Defendants will have to satisfy the extraordinary burden of demonstrating "cause" to override the Bankruptcy Code's fundamental policy of ensuring the equitable treatment of creditors within the bankruptcy case. 11 U.S.C. § 362(d)(1). *See also Fernstrom Storage & Van Co.*, 938 F.2d at 735 (the Seventh Circuit adopted a three factor test for determining whether "cause" exists justifying relief from the stay).

Finally, the non-AmeriDebt defendants cannot circumvent the stay by proposing a new settlement that excludes AmeriDebt. Where the identity of interests between the debtor and the other defendants is such that the debtor is the true party in interest, and a judgment against the others will, in effect, be a judgment against the debtor, the entire case should be stayed. *Fernstrom Storage & Van Co.*, 938 F.2d at 736 (*citing A.H. Robins Co., Inc. v. Piccinin,* 788 F.2d 994, 999 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986)). Here, Plaintiffs allege that "AmeriDebt, Debticated and Infinity are several arms of a single commercial enterprise run by

and for the benefit of Messrs. Andris and Eriks Pukke," and "[e]ach of the defendants is the alter ego of all of the other defendants." (Second Am. Compl. ("Compl.") at ¶ 2). Defendants' Response, discussing AmeriDebt's central role in the enterprise, makes clear that AmeriDebt is inextricably intertwined with the other defendants. According to the Defendants' Response, Defendant Andris Pukke ("Pukke") helped to found AmeriDebt, and subsequently founded Defendant DebtWorks, Inc. ("DebtWorks"), a for-profit company servicing the supposedly non-profit AmeriDebt (where his wife was on the board). (Def. Resp. at 10). At the beginning of 2003, DebtWorks' management bought the company's assets, via a loan from DebtWorks/Pukke, and re-named the company, The Ballenger Group, L.L.C. ("Ballenger"). (Def. Resp., Ex. 2). Ballenger is also a Defendant under the proposed settlement.

Moreover, even if AmeriDebt is not contributing directly to the proposed monetary settlement – which is unclear – AmeriDebt is effectively funding it.[4] AmeriDebt continues to pay Ballenger for servicing its debt management plans ("DMPs"), and Ballenger in turn pays all its net profits to DebtWorks/Pukke in loan repayment. (Loan Agreement Among DebtWorks, Inc., The Ballenger Group, LLC, and Ballenger Holdings, LLC Dated as of October 31, 2003, Ex. 2 at ¶ 3.1(b)-(c)).

Additionally, by contract, AmeriDebt must indemnify DebtWorks and Ballenger for all costs, expenses, and judgments arising out of any law violation. (Def. Response, Ex. 27 at ¶¶ 10(a)(v) and 10(b); Fulfillment Agreement effective Aug. 15, 2001, Ex. 3 at ¶¶ 5.A.(v) and

[4]In addition to the monetary relief, the proposed settlement includes injunctive relief – albeit weak – against AmeriDebt. The automatic stay still precludes the settlement from going forward in this case because it is the continuation of an action against AmeriDebt prohibited by 11 U.S.C. § 362(a)(1).

5.B.; Amendment to Fulfillment Agreement effective March 1, 2003, Ex. 4 at 2; Fulfillment Agreement effective June 1, 2003, Ex. 5 at ¶ ¶ 5.1 and 5.3). Where a judgment against the non-debtors will affect the debtor's assets because the debtor is obligated to indemnify the non-debtor defendants, either by contract or state law, the case against the non-debtor defendants should be stayed. *El Puerto de Liverpool S.A. de C.V. v. Servi Mundo Llantero, U.S.A., Inc. (In re Kmart Corp.)*, 285 B.R. 679, 688 (Bankr. N.D. Ill. 2002) (*citing In re Eagle-Picher Indus., Inc.*, 963 F.2d 855, 860 (6th Cir. 1992); *A.H. Robins*, 788 F.2d at 1007; *American Film Techs v. Taritero (In re American Film Techs)*, 175 B.R. 847, 850-51 (Bankr. D. Del. 1994); *Trimec, Inc. v. Zale Corp.*, 150 B.R. 685, 687 (N.D. Ill. 1993)). *See also Gillman v. Continental Airlines (In re Continental Airlines)*, 177 B.R. 475, 481 n.5 (D. Del. 1993).

In sum, clearly, the settlement as currently proposed violates the stay and cannot proceed. Moreover, the Defendants are so intertwined that AmeriDebt cannot simply be severed from the settlement. Therefore, the automatic stay should apply to prevent the settlement from going forward at all, regardless of whether AmeriDebt is a party.[5] Of course, at this point, the Defendants have not even proposed a settlement without AmeriDebt.

II. This Court Must Determine Whether The Stay Applies Before It Can Consider the Proposed Settlement

The above discussion confirms that before this case proceeds any further, the Court must

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[5]Indeed, the U.S. Trustee's office, a component of the Department of Justice charged with monitoring and administering the bankruptcy system, has requested that the bankruptcy court appoint a Chapter 11 trustee to take over management of AmeriDebt, based on its allegations that AmeriDebt breached its fiduciary duty as an alleged non-profit corporation through its "abdication of all management, operational and financial accounting responsibilities to The Ballenger Group." (*See* Motion of the United States Trustee for Appointment of a Chapter 11 Trustee, Ex. 6 at 16). The U.S. Trustee also alleges that AmeriDebt appears to administer its assets for the benefit of Ballenger, Pukke, and Pukke's company, DebtWorks. (*Id.*)

determine the applicability of the stay. If the stay applies, the Court can not consider the merits of the proposed settlement. The Court has jurisdiction to determine whether this action, including the proposed settlement, is stayed. *See, e.g., NLRB v. Edward Cooper Painting, Inc.*, 804 F.2d 934, 939 (6th Cir. 1986); *Baldwin-United Corp. Litig.*, 765 F.2d 343, 347 (2d Cir. 1985); *NLRB v. Evans Plumbing Co.*, 639 F.2d 291 (5th Cir. 1981); *NLRB v. Sawulski*, 158 B.R. 971, 975 (E.D. Mich. 1993); *In re Montana*, 185 B.R. 650, 652 (Bankr. S.D. Fla. 1995) (Cristol, C.J.); *Sea Span Publ'ns, Inc. V. Greneer (In re Sea Span Publ'ns, Inc.),*, 126 B.R. 622, 624 (Bankr. M.D. Fla. 1991).

As discussed previously, the FTC believes that this action should be stayed as to all Defendants, including AmeriDebt. If the Court determines, however, that the proposed settlement can proceed notwithstanding AmeriDebt's bankruptcy filing, the settlement should nonetheless be rejected because the plaintiffs have not adequately represented the class and the settlement is wholly inadequate for consumers.

III. Class Counsel and the Named Class Representatives Have Not Adequately Represented the Class.

As a threshold matter, the proposed settlement cannot proceed because it does not meet the certification criteria of the Illinois Code of Civil Procedure, 735 ILCS 5/2-801 (2004). Specifically, Section 2-801(3) provides that a class action may be maintained only if "[t]he representative parties will fairly and adequately protect the interest of the class." Judges are expected to scrutinize with care the terms of proposed settlements in order to make sure that class counsel are adequate fiduciaries for the class. *Mirfasihi v. Fleet Mortg. Corp.,* 356 F.3d 781, 785 (7th Cir. 2004).

A. Class Counsel Did Not Conduct Sufficient Discovery or Engage in Hard-Fought Negotiations in Reaching the Proposed Settlement.

Plaintiffs' Response confirms that class counsel have not adequately represented the class. Indeed, plaintiffs' primary argument in support of the settlement is that the Defendants do not – or will not – have the ability to pay more than $8 million. Plaintiffs support that argument, however, by reference only to Defendant AmeriDebt. For example, plaintiffs point to AmeriDebt's bankruptcy filing and its public announcement that it would cease originating new customers in October 2003.[6] Plaintiffs also point to an alleged investigation by the IRS and the Justice Department, and speculate that it will result in the forfeiture of all of the Defendants' assets. In stark contrast, the (non-AmeriDebt) Defendants' 57-page response never once argues that they do not have the ability to pay more than $8 million. Indeed, in a telephone conversation, defense counsel confirmed that they are not arguing ability to pay, and that class counsel would not have information to support such an argument. *See* Decl. of Lucy E. Morris, Ex. 7. One need only read plaintiffs' response to see that they have no such support:

> Plaintiffs judged Defendants' initial inquiries towards settlement as arising from a dwindling financial situation and based on a declining capacity to pay. Plaintiffs did not need any discovery or statements by Defendants to make this judgment because it was obvious ...

(Pls.' Resp. at 14).

Plaintiffs' Response also concedes that class counsel did not take *any* depositions, other than confirmatory depositions of two *defense experts*, who, once again, only considered issues

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[6]Plaintiffs argue that "Defendants' decision to shut down its operations in October 2003" (*see* Pls.' Resp. at 3; emphasis added) justifies the weak settlement, yet it was only one defendant – AmeriDebt – that announced it would stop enrolling new customers. The other seven Defendants have not gone out of business, and indeed Defendant Ballenger continues to service the DMPs of AmeriDebt, Debticated, and other debt management firms.

relating to AmeriDebt. (Pls.' Resp at 13). Class counsel have not taken a single deposition relating to the other Defendants, or to the 11 debt management firms whose customers would be included in the class. Incredibly, plaintiffs assert that they "can not strengthen their case or obtain a better settlement by deposing anyone" (*Id.*), but clearly this can not be the case. In any event, it is their *fiduciary duty* to the class to *investigate* each of the Defendants – including the defendant's ability to pay – rather than rely solely on one defendant's bankruptcy filing to support a nationwide settlement releasing the claims of almost 500,000 consumers.

The record also establishes that class counsel have conducted virtually no written discovery of the non-AmeriDebt Defendants. In connection with motions to dismiss, class counsel conducted limited written discovery on the issue of personal jurisdiction over Andris Pukke and DebtWorks. After the Court ruled on the motions and dismissed Pukke from the case, Plaintiffs entered into the proposed settlement without any further fact discovery.

Moreover, it is clear from the parties' responses that class counsel did not hire their own experts and did not create their own damages model, but rather relied on the Defendants' experts and the Defendants' damages model to support this one-sided deal.

Under these circumstances, it is not surprising that the Plaintiffs' Response makes no effort to argue that the proposed settlement is the result of hard-fought negotiations. And while the Defendants' Response contends the settlement was the result of "arms-length bargaining" (Defs. Response at p. 46), it does not support that argument with any facts. Indeed, the Defendants' Response corroborates the statements made in the Declaration of David L. Vendler, counsel in the *Polascek* action. According to Defendants, they began settlement negotiations by presenting the same offer on the same day to both the *Cass* and *Polascek* attorneys. As is typical

in hard-fought negotiations, Mr. Vendler proposed a counteroffer that the Defendants viewed as too high. In contrast, according to the Defendants, the *Cass* attorneys made a counteroffer that was "reasonable to the Defendants," and a settlement was reached. The Defendants' brief does not disclose the details of the "counteroffer" made by the *Cass* attorneys, but it could not have been significant – neither the Defendants nor the Plaintiffs dispute the statement in Mr. Vendler's declaration that the offer the Defendants presented on December 18, 2003 "was same in all practical respects to the terms of the proposed Illinois Action settlement." *See* Vendler Decl., ¶ 10. Thus, it appears that the proposed settlement may be the product of a "reverse auction" and should be rejected on that basis alone.

As discussed previously, class counsel were in a weak bargaining position in *Cass*: the complaint only alleged state law claims; the class had not been certified; the case named only two defendants; and they faced a serious summary judgment challenge based on the weak merits of Cass's individual claim. While this situation might warrant an individual settlement on behalf of Cass, it does not justify the proposed nationwide settlement affecting the rights of some 500,000 consumers.

B. The Named Class Representatives Do Not Adequately Represent the Class.

Class counsel and the named class representatives also cannot adequately represent the divergent interests of the various subgroups within the class, in particular the interests of consumers who fall within "Class IV" and are eligible for only $10. The reason for this is that Cass, an AmeriDebt customer,[7] and Huggins, a Debticated customer, cannot adequately represent

[7]In addition, Cass cannot adequately represent the class because he is a customer of AmeriDebt, which is in bankruptcy and subject to the automatic stay of the Bankruptcy Code.

the customers of the other 11 debt management firms who fall within "Class IV," because they have had no dealings with those firms. Cass and Huggins are not adequate representatives of "Class IV" members simply because, as Defendants argue, their DMPs may have been serviced by the same entities. Indeed, the primary allegations in this case relate to enrollment, not servicing, and the proposed claims process asks questions solely related to enrollment, *e.g.*, "Did you believe you had to make an initial contribution to the Agency in order to receive services from the Agency?" Although Plaintiffs argue that DebtWorks/Ballenger are also liable for the alleged practices, this does not make Cass and Huggins adequate representatives for consumers who enrolled with other debt management firms – in particular, where Plaintiffs have conducted no discovery to justify the disparate treatment of these consumers under the settlement.[8]

Similarly, Cass and Huggins are not adequate representatives with regard to Defendant Infinity – a loan company owed by Andris Pukke – because they apparently never had any dealings with Infinity. As part of the proposed settlement, Infinity/Pukke would benefit from a broad release, but members with claims against Infinity presumably would fall under "Class IV" and be eligible for only $10. It is unclear how such a class member would make a claim, however, since the proposed questionnaire only asks questions relating to enrollment with debt management companies. There are no questions that would allow a consumer to make a claim against Infinity. In short, under the settlement, Infinity would receive a broad release without providing any benefit to the class.

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[8]Similarly, this problem is not fixed because class members will not release claims against the other 11 "non-profit" debt management firms. Plaintiffs' response concedes that these "non-profits" would not, as a practical matter, have any money to pay claims against them: "Because the other Defendants operated as non-profit entities, only DebtWorks and Pukke have any money left, so it is crucial to be able to recover against them." (Pls.' Resp. at 6.)

IV. The Proposed Settlement is Neither Fair, Reasonable, nor Adequate

A class action agreement must be fair, reasonable and adequate. *Langendorf v. Irving Trust Co.*, 614 N.E.2d 23, 28 (Ill. App. Ct. 1992), *abrogated on other grounds by Brundidge v. Glendale Fed. Bank,* 659 N.E.2d 909 (Ill. 1995). In reviewing the fairness of a proposed class action settlement, the courts consider several factors, including: (1) the strength of the case for plaintiffs on the merits, balanced against the money or other relief offered in settlement; (2) the defendant's ability to pay; (3) the complexity, length and expense of further litigation; (4) the amount of opposition to the settlement; (5) the presence of collusion in reaching a settlement; (6) the reaction of members of the class to the settlement; (7) the opinion of competent counsel; (8) the stage of proceedings and the amount of discovery completed. *City of Chicago v. Korshak*, 565 N.E. 2d 68, 70 (Ill. App. Ct. 1990). In this case, the application of the *Korshak* factors demonstrates the unfairness of the proposed settlement.

A. The Amount of Money Offered in the Proposed Settlement, Balanced Against the Strength of the Case, Is Neither Fair Nor Reasonable

1. The Total Settlement Amount Is Inadequate

The proposed settlement would release the Defendants from at least $300 million in liability for pennies on the dollar. Neither the Plaintiffs nor the Defendants dispute the total amount of money that consumers have paid in "contributions." They concede that the class consists of almost 500,000 consumers, and they do not contest that class members have paid, on average, $300 for the initial "voluntary contribution" and $300 for monthly contributions. Thus, the total consumer injury from "contributions" alone could total as high as $300 million. This does not even include other sources of consumer injury, such as injury caused by Pukke's loan company, Infinity, and injury caused by Defendants' failure to distribute consumers' first

payments to creditors.

Plaintiffs' assertion that class members will be eligible for a refund of up to $150 is seriously misleading. Only the "Class I" members are eligible for "up to" this amount, and even those members likely will not receive that amount. According to Defendants' records, "Class I" consists of 136,996 class members. (Duarte Decl., Ex. 1.) If each of these class members made a claim – as they should, since the Defendants gave them "poor disclosures" – the total amount of their collective claims would be $20.5 million, nearly three times the available redress pool (assuming $1 million in administrative costs). After adding in the claims of the 331,756 class members in the other subgroups, the pro rata return for Class I would be even smaller. Similarly, "Class II" members would not receive $30, but a much smaller share of that amount, perhaps even smaller than the $10 promised to members in Classes III and IV. Thus, under the settlement, *the amount that class members will receive – regardless of their sub-group – is likely to be less than what they paid for just one monthly contribution*. This is akin to a coupon settlement that provides virtually no benefit to consumers.

The parties attempt to justify this paltry settlement by arguing that the amount is reasonable in light of the Plaintiffs' claims. Plaintiffs made no effort to quantify the net expected value of continued litigation to the class, however, and Defendants' self-serving risk analysis is seriously flawed. The FTC disputes the parties' analyses of the three major claims at issue: (1) Defendants engaged in deceptive practices in collecting up-front fees from consumers in contravention of their promises of free services; (2) Defendants engaged in deceptive practices by representing that AmeriDebt and Debticated were non-profits; and (3) Defendants violated the Credit Repair Organizations Act ("CROA"). These claims have substantial merit and should not

be discounted to mere pennies on the dollar.

2. Defendants' Analysis of the Likelihood of Success on the Deception Claims Is Seriously Flawed

Under the Illinois Consumer Fraud Act ("ICFA"), a representation, omission, or practice is deceptive if it creates the likelihood of deception or has the capacity to deceive consumers acting reasonably under the circumstances. *Chandler v. Am. Gen. Fin., Inc.,* 768 N.E.2d 60, 68 (Ill. App. Ct. 2002). Deception includes misrepresentations of material facts made for the purpose of inducing consumers to purchase goods and services. *Id.* at 69; *FTC v. World Travel Vacation Brokers, Inc.,* 861 F.2d 1020, 1029 (7th Cir. 1988).[9] Significantly, a law violation occurs "if it induces the first contact through deception, even if the buyer later becomes fully informed before entering the contract." *Resort Car Rental System, Inc. v. FTC*, 518 F.2d 962, 964 (9th Cir. 1975). Longstanding law under the ICFA holds that a representation is deceptive if the overall "net impression" – taken as a whole – is likely to mislead consumers. *People ex rel. Neil F. Hartigan v. Maclean Hunter Pub. Corp.,* 457 N.E.2d 480, 486 (Ill. App. Ct. 1983).

Defendants assert that the evidence "establishes" that at most only about 10% of consumers mistakenly thought that their contributions to AmeriDebt and Debticated were mandatory. (Defs.' Resp. at 20; Duarte Decl. ¶ 15(a)). This is a strained interpretation, based upon an unauthenticated report by a non-expert witness, Bear Stearns Merchant Banking, upon which class counsel never conducted any discovery. In any event, the report does not lead to the conclusion reached by Defendants. Indeed, a very different conclusion that can be reached from the Bear Stearns' report is that the contributions are in fact mandatory – until sometime in 2002,

[9]When interpreting the ICFA, courts are required to consider federal court opinions relating to the FTC Act. 815 ILCS 505/2.

Bear Stearns reports that nearly 100% of AmeriDebt's customers paid the initial contribution. There could be a number of reasons for the alleged 10% drop in 2002, but it certainly does not "establish" that only 10% of consumers were deceived throughout the relevant time period.[10]

Nor does the Defendants' expert, Gary Ford, provide any analysis as to whether the level of complaints about the initial payment dropped over time, or even about any rate of deception. (*See* Def. Ex. 49). Ford's report merely states that he reviewed the electronic notes in AmeriDebt's computer system of 400 consumers and found that 6.5% of these consumers had indicated they did not know about the initial contribution or complained about it. Defendants assert that the 6.5% figure in Ford's report is an upper bound on the number of deceived consumers; however, there is no indication that AmeriDebt's complaint handling and record keeping procedures were adequate. More importantly, consumers who never knew about the initial contribution certainly would not complain about it. In addition, it is likely that many consumers who believed the contribution was mandatory or were otherwise unhappy would not take the time to call to complain – especially given that most consumers stayed on the program for less than a year. (Def. Ex. 11 at 4). Certainly, the records of the defendant – the one charged with deception – should not be accepted at face value as proof of anything.

Plaintiffs also allege that if a consumer tried to refuse to allow AmeriDebt or Debticated to use the first payment as a "voluntary contribution," the employees were trained to tell him that upon further review he does not qualify for the program. (Compl. ¶ 38). Although Defendants state that the evidence "clearly establishes" that those consumers who refused to make

[10]It is worth pointing out that these and similar arguments are made by the Defendants, as advocates, and not by the Plaintiffs, who are the moving parties in support of the settlement.

contributions received the same services as those who made contributions (Def.'s Resp. at 19), the documentation that supposedly supports this assertion only shows that there were codes in the system in the event consumers did not make the "contributions."[11] The documentation does not establish whether consumers who refused to make contributions were treated differently by employees, who received bonuses based on the amount of consumers' contributions. In any event, the relevant question is not whether consumers who did not make the contribution were denied services, but rather whether consumers who paid the "contribution" were misled. Stated differently, the fact that some consumers may have successfully overcome the Defendants' deception does not mean that others were not deceived. Moreover, the existence of some satisfied customers does not constitute a defense to deception. *FTC v. Amy Travel Service, Inc.*, 875 F.2d 564, 572 (7th Cir. 1989).

Defendants try to convince this Court that the settlement figure is reasonable because it does not factor in certain benefits that consumers allegedly received from participating in a DMP. In a deception case, however, the proper amount of relief is the full amount lost by consumers. Courts do not give credit for the value of a product in assessing consumer injury. *See FTC v. Kuykendall*, No. 02-6101, 371 F.3d 745, 2004 U.S. App. LEXIS 11472, at *55-6 (10th Cir. June 10, 2004); *FTC v. Febre,* 128 F.3d 530, 535 (7th Cir. 1997); *FTC v. Gem Merchandising Corp.*, 87 F.3d 466, 468 (11th Cir. 1996); *FTC v. Figgie Int'l, Inc.,* 994 F.2d 595, 606-07 (9th Cir. 1993). Thus, the expert report of David Painter, purporting to show that a certain percentage of AmeriDebt consumers would have received financial benefits from completing a DMP, does not

[11]The FTC believes that these codes were used almost exclusively for enrolling consumers from states – Maryland and Virginia – that prohibited initial contributions.

help them. (*See* Def. Ex. 18 at 4).

3. Defendants Underestimate Plaintiffs' Likelihood of Success on the Claim that AmeriDebt and Debticated are "Sham" Non-Profits.

Defendants argue that AmeriDebt's and Debticated's non-profit claims were not material to consumers. (Defs.' Resp. at 26). Yet Defendants repeatedly told consumers that AmeriDebt and Debticated were non-profits in their advertising and marketing materials, as well as in their sales scripts. Express claims – like the Defendants' non-profit claims – are presumed material. *FTC v. SlimAmerica, Inc.*, 77 F. Supp.2d 1263, 1272 (S.D. Fla. 1999); *FTC v. Patriot Alcohol Testers, Inc.*, 798 F. Supp. 851, 856 (D. Mass. 1992).

Defendants cite a Visa U.S.A., Inc. report in an attempt to show that the non-profit claim was not material to consumers. (Defs.' Resp. at 27). In fact, the Visa study asked a different question to consumers utilizing DMPs. It asked consumers why they sought financial counseling, not why they chose one organization over another. (Def. Ex. 14 at 19). It gave the consumers multiple choice options such as "overextended," "collection tactics," and "unemployment," without including an option for anything similar to "the Agency was non-profit." Thus, the Visa report has no bearing on this issue.

Not only are Defendants' non-profit claims material to consumers, but they are also false. Indeed, Plaintiffs' Complaint alleges that the purpose of AmeriDebt and Debticated was to funnel profits to Defendant Andris Pukke ("Pukke") through for-profit corporations under his control, primarily DebtWorks and Ballenger. (Compl. at ¶ 27). The scheme was extremely lucrative. Indeed, in 2002 alone, DebtWorks made over $26 million in profits. (Ex. 8).

The AmeriDebt and Debticated relationships to DebtWorks and Ballenger are starkly different from a true non-profit's arrangements with for-profit suppliers. The U.S. Trustee's

office has recognized this – in the AmeriDebt bankruptcy case, that office requested that the court appoint a trustee, in part because it found that AmeriDebt had administered its assets for the benefit of Ballenger and for the ultimate benefit of Pukke/DebtWorks. (*See* Ex. 6 at 16). The U.S. Trustee also alleged that the contract between AmeriDebt and Ballenger was "grossly one-sided" in favor of Ballenger. (*Id.* at 17). It is likely that Plaintiffs (upon completing sufficient discovery) would be able to prove that AmeriDebt and Debticated did not operate as true non-profits, and that class members suffered damages as a result of participating in DMPs through AmeriDebt and Debticated, rather than choosing a true non-profit for financial counseling and a DMP, if appropriate. Indeed, the Bear Stearns report touted by Defendants found that the initial fee for an "Independent" agency such as AmeriDebt was 15 times higher than that of the traditional non-profit credit counseling agencies, and also that consumers stayed on the plans of traditional non-profits longer. (Defs. Ex. 11 at 4).

4. The Proposed Settlement Undervalues Plaintiffs' CROA Claims.

The proposed settlement would release class members' claims under the federal Credit Repair Organizations Act ("CROA"), a claim that class counsel added to the Complaint solely for purposes of settlement. Class counsel have done no discovery on this issue, and there is no indication that class counsel have valued this claim in agreeing to the settlement. The claim has substantial merit, however.[12]

Defendants claim not to be credit repair organizations covered by the CROA, but

[12]It is irrelevant that the FTC's district court complaint does not yet include a CROA claim. The FTC has wide prosecutorial discretion and chooses cases and claims to pursue for a variety of reasons. The significant point here is that class counsel have included a CROA claim – but the settlement does not reflect the strength of that claim.

Plaintiffs have strong arguments that Defendants are covered by the statute, which states:

> The term 'credit repair organization'--
> (A) means any person who uses any instrumentality of interstate commerce or the mails to sell, provide, or perform (or represent that such person can or will sell, provide, or perform) any service, in return for the payment of money or other valuable consideration, for the express or implied purpose of–
> (i) improving any consumer's credit record, credit history, or credit rating; or
> (ii) providing advice or assistance to any consumer with regard to any activity or service described in clause (i)....

15 U.S.C. § 1679a.

In this case, the Plaintiffs have alleged the type of practices covered by the plain language of the statute. In promoting their services, Defendants repeatedly represent that they provide services for the purpose of improving consumers' credit records, credit histories, or credit ratings. (Ex. 9; Ex. 10; Defs.' Ex. 50 at 8; Compl. Ex. 4). Defendants provide these services in exchange for the payment of money, which takes the form of "contributions."

Defendants may not escape coverage under the CROA by virtue of their alleged "non-profit" status. Plaintiff Polacsek's CROA claim has already survived a motion to dismiss based on Debticated's alleged "non-profit" status. And in the AmeriDebt bankruptcy proceeding, the IRS has filed a Proof of Claim for almost $15 million in taxes owing for the years 2000, 2001, and 2002 – clearly, the IRS no longer views AmeriDebt as "tax exempt." (Ex. 11). In any event, courts should review *de novo* IRS determinations of tax-exempt status. *Basic Unit Ministry of Alma Karl Schurig v. United States*, 511 F. Supp. 166, 168 (D.D.C. 1981), *aff'd per curiam*, 670 F.2d 1210 (D.C. Cir. 1982).

Defendants argue that the CROA does not apply because any credit repair claims were "ancillary" to their business. The cases cited by Defendants, concerning a car dealership and a

debt collector, are inapposite. Defendants' claims about repairing credit histories are a central part of their advertising and a central purpose of their DMP product; in contrast, the car dealership in *Wojcik v. Courtesy Auto Sales*, 2002 WL 31663298 (D. Neb. Nov. 25, 2002) merely happened to offer financing to buyers of its vehicles, and did not offer products designed specifically to improve credit ratings. *Id*. at *8. The second case cited by defendants, *White v. Financial Credit Corp.*, 2001 WL 1665386 (N.D. Ill. Dec. 27, 2001), also concerns a business that, unlike Defendants, did not offer a service for the purpose of improving credit ratings.

It is also unimportant that Defendants did not keep track of how much money they received from consumers specifically because of their representations about improving credit histories. Several courts have ruled that the CROA does not require that a consumer's payment to a credit repair organization be itemized so that part of it is specifically designated for credit repair services. *Bigalke v. Creditrust Corp.*, 162 F. Supp. 2d 996, 998 (N.D. Ill. 2001); *Parker v. 1-800 BAR NONE*, 2002 WL 215530 *5 (N.D. Ill.). To require such a showing would only reward Defendants for their deceptive practices in touting the benefits of their services while hiding that they keep consumers' first payments as a fee.

Under the CROA, damages are the *greater* of the amount of any actual damages "or any amount paid by the person to the credit repair organization." 15 U.S.C. § 1679g(a). Defendants would have this Court depart from the plain language of the CROA again to hold that "any amount paid" should not mean "any amount paid." Defendants try to stretch the meaning of the phrase to include the amounts that consumers sent to the Defendants for the benefit of their creditors; however, these amounts were not paid to the Defendants, they were paid to the creditors. Thus, these amounts are not included in the proper calculation of amounts paid to the

credit repair organization. *FTC v. Gill*, 265 F.3d 944, 958 (9th Cir. 2001).

Defendants also seek to avoid their potential liability under CROA by claiming that, were consumers to be awarded $300 million or more, such an award would comprise a windfall. To the contrary, given the scope of Defendants' deception, awarding "amount paid" damages would be appropriate, and the comparatively tiny sum contained in the proposed settlement would do little justice. *See Kingsvision Pay Per View, Ltd. v. Boom Town Saloon, Inc.*, 98 F. Supp. 2d 958, 966 (N.D. Ill. 2000) (the court can tailor statutory damages to approximate consumer losses in appropriate circumstances).[13]

Finally, Plaintiffs attempt to convince this court that a victory on a CROA claim would be useless because the IRS would swoop in and confiscate all of Defendants' assets. This is entirely speculative and not a basis upon which to justify the proposed settlement.

B. Other *Korshak* Factors Demonstrate the Unfairness of the Settlement

As discussed earlier, the Defendants do not even attempt to argue that they cannot afford a higher sum. Plaintiffs do not present evidence to the contrary. Their assertion that AmeriDebt's bankruptcy filing shows that Defendants cannot pay additional restitution to consumers is unfounded, as the seven other defendants in the case are not in bankruptcy and could likely pay much more. Indeed, AmeriDebt's assets are tied up in bankruptcy court, yet the other Defendants are not seeking to stall implementation of the settlement because they need

[13]The case of *Frank Music Corp. v. Metro-Goldwyn-Mayer Inc.*, 886 F.2d 1545 (9th Cir. 1989), which Defendants cite as barring windfalls to plaintiff, is irrelevant as it concerned a dispute under the Copyright Act in which plaintiffs had already received a share of defendant's profits and might have received statutory damages in addition to this. *Id.* at 1555. Here, defendants are hardly in the same situation, as they have offered nothing comparable to the real loss suffered at their hands by consumers.

money from AmeriDebt to go forward with the settlement. Thus, it appears that the other Defendants can pay the money to satisfy a judgment if this Court grants final approval to the proposed settlement. Thus, the Court should not approve this settlement based on Plaintiffs' groundless claims that Defendants lack money to pay more.[14]

Another *Korshak* factor in assessing fairness is the amount of opposition to the settlement. Here, there is substantial opposition to the settlement from the FTC and the Attorneys General of Illinois, Texas, and Missouri. The mission of all of these governmental entities is to protect the interests of consumers. The opinions of these governmental agencies outweigh the self-serving opinions of counsel for the settling parties, in particular where evidence exists that the settlement was the product of inadequate representation, a "reverse auction," or collusion. Finally, the early stage of the proceedings and the lack of any meaningful discovery also support rejection of the proposed settlement.

V. The Revised Claim Form Has Several Flaws.

The parties made some positive changes to the notice and claim form, although these changes do not cure the settlement's substantive deficiencies. Moreover, the revised claim form still fails the consumers most harmed by Defendants' practices: those consumers who never realized that their first payment was kept by AmeriDebt or Debticated rather than disbursed to creditors. Consumers must answer this question on the claim form:

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[14]Neither party has disclosed the amounts that each defendant will contribute to the settlement (if approved). This is relevant to assess whether any party is receiving the benefit of the release without a concomitant benefit to consumers. We question the propriety of a settlement where some of the parties that benefit from released claims do not contribute to the settlement, especially where they has been no showing that any party lacks the financial ability to make a contribution.

Did you believe you had to make an initial contribution to the Agency in order to receive services from the Agency? (Circle One)

YES NO

Consumers who do not know that the agencies took their first payments as "contributions" would answer "no" to this question and would not receive a settlement payment. The same holds true for the next question about the monthly "contributions." It is no surprise that Defendants would insist on these questions rather than allowing an additional question that asks whether consumers understood that the agency would keep their first payment as a contribution. Defendants have an incentive to minimize valid claims, because their liability under the settlement could be as low as $2 million if they are successful in doing so.

Moreover, the claim form intended for consumers who respond to the publication notice has several unnecessary questions. (*See* Def. Ex. 6). While it is reasonable to ask question one (the name of the CCA that solicited the consumer), questions two, three, and four ask for information that would be readily available to Defendants once the claimant provided the personal information requested in the first part of the form. The questions ask when the consumer entered into a DMP, whether the consumer made the full initial contribution, and whether the consumer made the full monthly contribution. These questions are superfluous and seem to be intended to discourage claims.

VI. Conclusion

The Court should stay this case because AmeriDebt has filed for bankruptcy. In the alternative, the Court should withdraw its preliminary approval of the settlement because class counsel and the named class representatives have not adequately represented the class, and the settlement is neither fair, reasonable, nor adequate.

Date: July 15, 2004

Respectfully submitted,

FEDERAL TRADE COMMISSION

WILLIAM E. KOVACIC
General Counsel

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LUCY E. MORRIS (admitted *pro hac vice*)
ALLISON I. BROWN (Attorney No. 6242582)
MAIYSHA R. BRANCH
JAMES SILVER
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Room NJ-3158
Washington, D.C. 20580
(202) 326-3295 (telephone)
(202) 326-3768 (facsimile)

DAVID O'TOOLE
Illinois Attorney No. 6227010
Federal Trade Commission, Midwest Region
55 East Monroe Street, Suite 1860
Chicago, Illinois 60603
(312) 960-5634 (telephone)
(312) 960-5600 (facsimile)