

Debt Settlement

1. What is a debt settlement company? How do these companies work? How much do they charge? Should I use one to get rid of my credit card debt?

A: Debt settlement companies work as a middleman between you and your creditor. If all goes well (and that's a big if), you should be able to settle your debts for cents on the dollar. You'll also pay a fee to the debt settlement company, usually either a percentage of the total debt you have or a percentage of the total amount forgiven.

If you'd asked me a few years ago about debt settlement companies, I probably would have told you to avoid them. But things have changed a bit. The Bankruptcy Reform Act of 2005 made it harder for individuals to file bankruptcy, which is always the last resort. Unfortunately, simultaneously consumers racked up so much debt that counseling companies — which are higher up on my list if you need help managing your debt — are sometimes unable to help. So if you fall into this camp, debt settlement may be something to consider.

Here's how it works: The debt settlement company will direct you to stop paying your creditor and instead send the money directly to them each month. The company's goal is to demonstrate to your creditor that you don't have the money to pay up — that's your leverage. After a few months, the company will typically go to the creditor and say, "I'm holding X dollars on behalf of your customer. He doesn't have the money to pay you, so you should take this amount as a settlement or you'll end up with nothing." If the creditor wants to get paid badly enough, it will take the money.

All of this sounds great, but there are negatives. For starters, during the three- to four-month stretch that you're not paying your creditor, your account will accrue late fees and possibly even "over the limit" fees. Both of those fees add to the total debt and to the debt settlement company's fee. Not paying

your creditors can do a serious number on your credit score, and having a settlement on your credit history drags it down even further. If you start out in the high 600s, for example, your credit score could be well into the 400s by the time you've gone through debt settlement, especially if you settle more than one account.

And besides: You really don't need to hire a debt settlement company to negotiate with your creditors. Unless you have multiple accounts that you need to negotiate and you think the project is just too big to tackle on your own, you're better off just calling your creditors directly. For what to say, see the script included with the next question.

I also need to know ...

Q: How much is working with a debt settlement company likely to cost me?

A: To be honest, you might have trouble getting a straight-up answer to this question even from the debt settlement company itself, and if you do, that's a reason to walk away. The best companies will charge a percentage, usually about 15%, of the amount of debt that they're able to settle for you. Others may charge 15% of the total debt you have when you enter the program. If the fee is calculated this way, not only are you paying too much but you're also not holding the company accountable to get you the best results.

But if you are able to settle, you'll be getting off rather easy. Debt settlement companies can sometimes get you off the hook for a large percentage of your debt — in many cases, up to 50% will be written off.

Q: How long will the settlement stay on my credit report?

A: That you settled a debt instead of paying in full will stay on your credit report for as long as the individual accounts are reported, which is typically seven years from the date that the account was settled. Unlike with bankruptcy, there isn't a separate line on your credit report dedicated to debt settlement, so each account settled will be listed as a charge-off. If a debt has gone into collection, it will be on your report for 7 1/2 years from the date you fell behind with your creditor.

Q: How can I check a debt settlement company's credibility?

A: For starters, make sure that the company is a member of The Association of Settlement Companies (TASC), a trade association that represents debt settlement firms and outlines standards that they agree to meet. The association has a search tool on its Web site that allows you to find a registered member in your area. Once you've pinpointed a few viable choices, ask for an initial consultation. You should also make sure the company has a clean record with the Better Business Bureau (BBB), which you can do at www.bbb.org/us/.

Q: Do I need a lawyer?

A: You don't. If you're filing bankruptcy, you will likely want to hire an attorney. But for debt settlement, a company is sufficient, or as I said, you can often do the legwork on your own.

Four things you need to know about any debt settlement company **The fee:** It should be based on the amount of debt that the company is able to settle for you.

Red flag: If the company charges a percentage of your total debt upfront, walk away.

The return policy: There should be a money-back guarantee in place of at least 30 days.

Red flag: If the company doesn't offer a guarantee, find one that does.

The timeline: No company can promise an end date, but if you have multiple debts, the first one should be settled within a year.

Red flag: If a company promises a faster return, it may be spinning the truth.

Where is my money? Once you send it to the debt settlement company, it should be kept in an FDIC-insured bank account. (The FDIC, or Federal Deposit Insurance Corporation, insures bank deposits, among other duties.)

Red flag: If the company asks you to hold on to the money or doesn't keep it in an insured account, the company isn't doing its job.

An example You have \$35,000 in credit card debt that is settled through a debt settlement company. Forty percent of your debt, or \$14,000, is forgiven, and you pay \$21,000 in full upfront. The debt settlement company charges you 15% of the amount of debt that is forgiven, or \$2,100.

- Total paid: \$23,100
- Total forgiven: \$14,000
- Total saved: \$9,000
- Total damage to your credit score: -150 points
- Stays on your credit report for 7+ years.

