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Special Issue on New Rule Preventing Bank Freezes of Exempt Federal Benefits

Watershed Treasury Rule Protects Exempt Federal Benefits from Garnishment

A new federal rule effective May 1, 2011 vastly strengthens protections for exempt federal benefits deposited into bank accounts.¹ The rule, announced by the Treasury Department and several benefits-paying agencies, will limit creditors' ability to garnish bank accounts that contain Social Security, Supplemental Security Income (SSI), VA, and certain other federal benefits.

Federal law makes these funds immune from seizure by creditors. But in practice, when a bank receives a garnishment order, it typically freezes the entire bank account up to the amount of the debt, even when the account contains protected funds. A beneficiary may be unable to access urgently needed funds for weeks or months. Often, the paperwork and procedures needed to end an illegal freeze prove too daunting for a recipient, so that a bank turns over supposedly "untouchable" funds to a creditor.

The new rule prohibits the practice of denying beneficiaries access to these essential funds in bank accounts. It requires all banks to determine whether certain exempt federal benefits have been electronically deposited within the preceding two months. If yes, the bank must protect whatever amount was deposited during that period. To protect funds deposited before the two-month window, or funds which have been transferred between accounts, the recipient will have to use state procedures.

The new rule represents the culmination of a four-year NCLC-led effort to win greater protections for these essential benefits in bank accounts.

How the New Rule Will Operate

The new rule applies to state and federal banks and credit unions and any other entity chartered under federal or state law to engage in the business of banking.² Upon receipt of a garnishment order against an account holder, the bank must review all accounts owned by that individual to determine whether any of the specified federal benefits were electronically deposited during the preceding two months (the "look-back period"). (The benefits-paying agencies are adding new electronic markers that banks will be permitted to rely on to determine whether an electronic deposit is an exempt bene-

fit.) If yes, then the bank must calculate the "protected amount." The "protected amount is the lesser of the sum of all exempt benefits electronically deposited into the debtor's account during the look-back period, or the balance of the account on the day the review is conducted."³

If the account contains a protected amount, the bank cannot freeze, or otherwise restrict the account holder's "full and customary" access to, that amount.⁴ The bank must give the beneficiary the same degree of access that was provided before the bank received the garnishment order.⁵

Upon determining that the account contains a protected amount, the bank must send the account holder a notice describing what the bank has done and giving some basic information about how to protect exempt benefits that exceed the protected amount.⁶ The rule protects the bank from contempt citations or similar penalties, and from any liability to the creditor, for preserving the debtor's access to the protected amount.⁷

Exceptions for Debts Owed to Federal Government or State Child Support Agency

The account review is not required and there is no automatic protection of any amount, however, if either the federal government or a state IV-D child support agency issued the garnishment order. These orders must contain a special notice.⁸ The rationale is that different exemption regimes apply in these cases. In these cases, the debtor can still assert exemptions, but must do so through the usual state procedures.⁹ Unfortunately, this exemption is too broad, as some benefits—such as SSI benefits—are not subject to the collection of child support.¹⁰

A Self-Executing Protection; Debtor No Longer Has Burden of Asserting Exemption at Any Stage

The problem that the new rule is designed to address is the temporary freeze of a debtor's bank account while the bank, the parties, and the court system sort out the question whether funds are exempt. But the effect of the rule is much more sweeping.

The new rule nullifies any requirement that the debtor take any affirmative step to assert an exemption for the protected amount. The bank has an unconditional obligation to make the protected amount available to the debtor. In addi-

¹ 76 Fed. Reg. 9939 (Feb. 23, 2011), to be codified at 31 C.F.R. §§ 212.1 to 212.12.

² 31 C.F.R. § 212.3 (definition of "financial institution"). This article will refer to all of these institutions as "banks."

³ 31 C.F.R. § 212.3.

⁴ 31 C.F.R. § 212.6(a).

⁵ 76 Fed. Reg. 9939, 9945 (Feb. 23, 2011).

⁶ 31 C.F.R. § 212.7. A notice is required only if the account had a positive balance on the review date. See also 31 C.F.R. pt. 212, app. A, Model Notice to Account Holder.

⁷ 31 C.F.R. § 212.10.

⁸ 31 C.F.R. § 212.4(a).

⁹ 31 C.F.R. § 212.4(a).

¹⁰ NCLC, Collection Actions § 12.5.10 (2008 and Supp.).

tion, the bank is prohibited from complying with any court order to pay the protected amount to the creditor—even if, for example, the debtor fails to comply with a state law requirement to assert the exemption or the state court concludes that the exemption was improper.

This conclusion is clear from three parts of the rule. The rule provides: “An account holder shall have no requirement to assert any right of garnishment exemption prior to accessing the protected amount in the account.”¹¹ Second, “[a] protected amount calculated and established by a financial institution pursuant to this section shall be conclusively considered to be exempt from garnishment under law.”¹² Third, the notice that the bank is required to send to the account holder says “You may use the ‘protected amount’ of money in your account as you normally would. *There is nothing else that you need to do to make sure that the ‘protected amount’ is safe.*”¹³

Commingled Funds, Co-Owners, Lump-Sum Payments

In some states, courts have held that exempt funds lose their protected status whenever they are commingled with non-exempt funds.¹⁴ The new rule’s protections apply whether or not the protected funds have been commingled with other funds: as long as the specified federal benefits were electronically deposited into the account during the look-back period, they are protected regardless of what other funds might be in the account.¹⁵

Nor does it make any difference if there is a co-owner on the account. Whatever amount of benefits was deposited during the look-back period is exempt, even if it was deposited in the name of the non-debtor co-owner.¹⁶

The rule does not contain any cap on the amount of benefits that are protected. If the beneficiary received a lump-sum payment by electronic deposit within the two-month look-back period, it is protected regardless of its amount. However, a lump-sum payment that remains unspent in an account will lose the rule’s automatic protection after two months. If a garnishment order arrives, the beneficiary will need to invoke whatever state procedures are available to protect the remainder of the lump-sum payment.

Also, if the exempt funds were electronically deposited into one account and then transferred into another account, the funds are not protected. The “protected amount” under the rule is limited to funds that were electronically deposited into each account the bank holds in the name of the debtor.¹⁷

Continuing Garnishments and Repeat Garnishments

According to the Treasury Department, in a few states creditors can obtain continuing garnishments of bank accounts, requiring the bank to monitor the account and garnish funds as new deposits come in.¹⁸ The rule prohibits a bank that is served with a continuing garnishment order from complying with that order’s ongoing requirements.¹⁹

Likewise, if the same garnishment order is served on a bank a second time, the bank is prohibited from taking any action on it.²⁰ The bank must, however, go through the account review procedure again and determine if there is a protected amount if the creditor obtains and serves a *new* garnishment order.

Banks may perceive it as a burden to perform repeat account reviews in response to multiple garnishment orders, particularly since they are not allowed to deduct any garnishment fees from the protected amount.²¹ For these reasons, banks may want to close a beneficiary’s bank account if repeat garnishment orders come in. While the supplementary material to the rule indicates that the new rule does not address this issue,²² the language of the rule requiring the bank to provide “full and customary access to the protected amount”²³ would appear to prohibit banks from closing accounts, as closing the account and sending a check for the remaining amount is not “full and customary access.”

Additionally, it may be a violation of the FDCPA, a state debt collection statute, or a state UDAP statute if a creditor or collector threatens or issues repeat garnishments as a means of harassing a debtor who is known to have only exempt funds in the account.²⁴

What If the Debtor Wants to Pay the Debt?

Occasionally a debtor may want to allow the garnishment to be implemented in whole or in part as a way of paying the debt. For example, the debtor may want to protect other non-exempt assets, and may be able to work out a release of the entire debt in exchange for allowing the bank to pay some part of the protected amount to the creditor. The new rule allows this, but only if the bank receives an express written instruction that is both dated and provided *by the account holder* to the bank *after* the date the garnishment order was served on the bank.²⁵ These requirements are designed to ensure that an account holder cannot instruct a financial institution in advance or in a standing agreement to use exempt funds to satisfy a garnishment order.²⁶ Other than this exception, “[t]he requirements of the rule may not be changed by agreement.”²⁷

Benefits the New Rule Does and Does Not Cover

In addition to Social Security, SSI, and VA benefits, the rule protects federal Railroad Retirement, federal Railroad Unemployment and Sickness, federal Civil Service Retirement System, and federal Employee Retirement System benefits.²⁸ The rule does not protect military retirement payments or other military benefits, but in announcing the rule, the agencies stated that its framework could be expanded in the future to protect these and other federal payments that are intended to be immune from garnishment.

¹¹ 31 C.F.R. § 212.6(a).

¹² 31 C.F.R. § 212.6(c).

¹³ 31 C.F.R. pt. 212, app. A, Model Notice to Account Holder (emphasis in original).

¹⁴ NCLC, Collection Actions § 12.6.3 (2008 and Supp.).

¹⁵ 31 C.F.R. § 212.5(d)(1).

¹⁶ 31 C.F.R. § 212.5(d)(2); 76 Fed. Reg. 9939, 9950 (Feb. 23, 2011).

¹⁷ 31 C.F.R. § 212.6(b).

¹⁸ 76 Fed. Reg. 9939, 9951 (Feb. 23, 2011).

¹⁹ 31 C.F.R. § 212.6(g).

²⁰ 31 C.F.R. § 212.6(f).

²¹ 31 C.F.R. § 212.6(h). See p.16, *infra*.

²² 76 Fed. Reg. 9939, 9946 (Feb. 23, 2011).

²³ 31 C.F.R. § 212.6(a).

²⁴ *Hogue v. Palisades Collection*, 494 F. Supp. 2d 1043 (S.D. Iowa 2007).

²⁵ 31 C.F.R. § 212.10(d)(3).

²⁶ 76 Fed. Reg. 9939, 9949 (Feb. 23, 2011).

²⁷ 76 Fed. Reg. 9939, 9949 (Feb. 23, 2011). See also 31 C.F.R. § 212.8(b) (rule does not invalidate terms or conditions of bank account agreements that are not inconsistent with the rule).

²⁸ 76 Fed. Reg. 9939 n.1 (Feb. 23, 2011); NCLC, Collection Actions § 12.5.5 (2008 and Supp.).

The new rule does not protect state benefit payments, such as state employee retirement benefits, workers compensation benefits, and unemployment compensation. These benefits, and other areas for state advocacy, are discussed later in this article.

Advising Clients: How to Make the Most of the New Protections

Exempt funds delivered by paper checks are not protected under the new rule, and can only be protected through the applicable state process.²⁹ Beneficiaries who are receiving paper checks should consider switching to electronic deposit or to the Direct Express card discussed in the next section.

The new rule will not provide full protection for benefit recipients who accumulate more than two months of benefits in their accounts, or who are expecting or have not yet spent down a lump-sum payment. These beneficiaries are vulnerable to garnishment of whatever amount exceeds the “protected amount.” For example, if an account contains \$5000, but only two \$2000 federal benefit payments were deposited within the last two months, the remaining \$1000 is vulnerable. Although already-paid benefits cannot be transferred onto the card, switching to the Direct Express card will protect the full amount of future benefits. In the alternative, the beneficiary can withdraw cash or spend down the bank account to protect the full amount, or can rely on asserting the exemption through state court procedures.

Beneficiaries should not transfer funds from one account to another, as the protections of the new rule will not follow the transferred funds. For example, if a beneficiary receives a \$1500 electronic deposit of federal benefits, and transfers \$1000 to a different account, leaving \$500 in the first account, only the remaining \$500 in the first account is protected by the rule. The \$1000 transferred to the second account is vulnerable, although state law may protect this sum if it can be traced to the exempt benefits.

If there is any chance that a beneficiary will need to rely on state exemption procedures, the account should include *just* exempt benefits, not any other amounts, as some courts have denied state exemptions when the exempt funds were commingled with non-exempt funds.³⁰

Direct Express Card Is a Watertight Way to Protect Full Amount of Social Security and SSI Benefits

The Direct Express card is a MasterCard-branded prepaid (stored value) debit card that receives all federal payments, including Social Security, SSI funds, and VA benefits. The Treasury has entered into a contract with Comerica Bank to automatically disburse Treasury payments onto each card on the payment date.³¹ The funds are loaded electronically and remotely, so beneficiaries need not go into a financial institution, government office, or check cashing outlet to obtain access to their benefits each month.

²⁹ By May 1, 2011, paper checks will no longer be available—with few limited exceptions—for delivery of federal benefits to new recipients. By March 1, 2013, the same rule will be applied to existing recipients. 31 C.F.R. pt. 208; 75 Fed Reg. 80,315 (Dec. 22, 2010).

³⁰ NCLC, Collection Actions § 12.6.3 (2008 and Supp.).

³¹ The terms of the Direct Express card are *not* set out by regulation, but only by Treasury’s contract with Comerica, and this contract is not public. Thus this article is based on Treasury’s statements found on its website.

Benefits paid through the Direct Express Card cannot be frozen or garnished, except to the extent that the funds are not exempt under federal law, such as seizure of benefits to pay child support or alimony. Because Comerica only loads exempt federal benefits onto the Direct Express Card, exempt funds are never commingled with non-exempt funds.

The Direct Express card can be used to withdraw cash from ATMs, make purchases at stores that accept MasterCard debit cards and get cash back when purchases are made, or make payments over the telephone or the Internet. It can be used to purchase money orders from the U.S. Post Office, but cannot be used to write personal checks. Unlike some bank accounts, there are no high overdraft fees or extortionately priced bounce loans. The card carries some fees, but they are relatively modest and recipients can avoid most of them.³² Signing up is easy.³³

Treasury Rule Preempts Weaker State Laws but Preserves Stronger Ones

Some state exemption statutes offer greater protection for federal benefits than the Treasury rule. Pennsylvania court rules protect the first \$10,000 of any account into which recurring exempt benefit payments are electronically deposited.³⁴ California provides an automatic exemption for up to \$2700 of directly deposited Social Security benefits,³⁵ which for some recipients may be more than the two months of benefits protected under the federal rule. New York protects a flat \$2500 if any reasonably identifiable exempt funds have been electronically deposited within forty-five days preceding service of a garnishment order.³⁶

The federal rule preempts state laws only to the extent that the state law prevents banks from complying with the rule. A state law that protects a higher amount than the federal rule is not preempted if the bank can comply with both requirements.³⁷ Likewise, a state law prohibiting a bank from freezing exempt funds deposited by check is not preempted.³⁸

State laws are preempted if they would stand in the way of the automatic, self-executing protection of federal benefits that the new rule requires. For example, state laws that require banks to freeze the “protected amount” or that require the benefit recipient to take affirmative steps to assert the exemption are preempted.

The rule includes a safe harbor for banks that comply with it in good faith,³⁹ intended primarily to prevent creditors from using state law remedies to force garnishee banks to freeze and turn

³² See <http://fms.treas.gov/directexpresscard/questions.html> for a series of questions and answers about the card. See NCLC, Consumer Banking and Payments Law § 7.10.2, Appx. 1.5 (4th ed. 2009 and Supp.).

³³ Social Security, SSI, and VA benefit recipients can sign up for the Direct Express Card by contacting Comerica Bank, at 1-877-212-9991 (toll-free) or by visiting www.USDirectExpress.com. For faster service, have available a copy of a Treasury check.

³⁴ Pa. R. Civ. P. 3111.1.

³⁵ Cal. Civ. Proc. Code § 704.080 (West).

³⁶ N.Y. C.P.L.R. § 5205 (McKinney).

³⁷ 31 C.F.R. § 212.9(b). See also 31 C.F.R. § 212.5(d)(6) (bank must perform account review without consideration for any instructions to the contrary in the garnishment order).

³⁸ As the agencies say in the supplementary material: “The fact that the rule does not address Treasury checks in no way affects an individual’s right to assert or receive an exemption from garnishment by following the procedures specified under the applicable law.” 76 Fed. Reg. 9939, 9941 (Feb. 23, 2011).

³⁹ 31 C.F.R. § 212.10(b).

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over exempt funds.⁴⁰ The safe harbor also protects the bank from any claim by an account holder for freezing exempt funds in the limited circumstance where a garnishment order from the federal government or a state child support enforcement agency resulted in the freezing of funds. Any argument that that the safe harbor provides cover for a bank's violation of a more protective state law is rebutted by the explicit language in the preemption provision: "(b) *Consistent law not preempted.* This regulation does not annul, alter, affect, or exempt any financial institution from complying with the laws of any State with respect to garnishment practices, except to the extent of an inconsistency."⁴¹ There is nothing inconsistent between this rule and a state's higher standard providing protection for exempt funds deposited by check, for example.

An Opening for Advocacy in the States

The rule does not depend on any action by states before it takes effect. However, it offers an opportunity for advocates to press for related improvements in their state garnishment rules. First, states will benefit if they revise their rules to incorporate the new federal requirements, so that creditors, debtors, banks, and courts do not inadvertently violate them.

Second, the state may want to draft language about state procedures and free legal services for banks to add, as is allowed by the federal rule, to the notice the bank is required to send the debtor about the garnishment.

Third, the federal rule only protects benefits that are exempt from garnishment under *federal* law. To protect similar state benefits, states will have to take steps on their own. But the new federal requirements create a convenient framework onto which state benefit protections can be easily added.

Finally, the new rule may create an opening to persuade states to exempt a flat amount, such as \$6000, in any bank account. Banks will prefer protecting a flat amount rather than having to calculate the amount of protected benefits deposited during the two-month look-back period.⁴²

⁴⁰ 76 Fed. Reg. 9939, 9952 (Feb. 23, 2011).

⁴¹ 31 C.F.R. § 212.9(b).

⁴² See 76 Fed. Reg. 9939, 9942 (Feb. 23, 2011) (noting bank comments).

The Next Frontier: Bank Setoff and Bank Fees

The rule prohibits banks from debiting fees for processing the garnishment against the protected amount. In addition, the bank may collect such a fee only on the day the account is reviewed, so the bank cannot collect a fee at all if an account contains only the protected amount on that day.⁴³ Except for these provisions, the rule is intentionally silent about bank setoff rights, including the key question whether a bank can use setoff against exempt funds.⁴⁴ However, the prohibition against banks taking fees from the protected amount is solid support for the idea that banks do not have unfettered access to exempt amounts.⁴⁵

Webinar on May 11, 2011

NCLC is sponsoring a webinar at 2:00 p.m. on May 11 on the rule and Treasury's new requirements for electronic deposit of federal benefits: "New Rules on Protection and Electronic Payment of Social Security." To sign up, follow instructions at www.nclc.org/conferences-training/national-elder-rights-training-project.html or email Jessica Hiemenz at jhiemenz@nclc.org.

Comments Due May 24

The "interim final" rule goes into effect on May 1, but Treasury is soliciting comments by May 24, suggesting that it is open to suggestions for revisions. To comment, go to www.regulations.gov and enter "3206-AM17" in the keyword field. Even comments that merely applaud Treasury and the other agencies for issuing the rule may be helpful in case collectors or others mount a late assault on the rule.

⁴³ 31 C.F.R. § 212.6(h). Garnishment fees may be deducted from amounts which are not included in the protected amounts.

⁴⁴ 76 Fed. Reg. 9939, 9947 (Feb. 23, 2011).

⁴⁵ See NCLC, *Consumer Banking and Payments Law* § 10.4 (4th ed. 2009 and Supp.) (legality of banks' use of setoff against exempt funds).