

Safer than the mattress?

A policy to ensure that Social Security and other exempt federal benefits remain safe from garnishment, attachment, and freezes when deposited in a bank account

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November 14, 2008

Introduction: How State Garnishment Procedures
Undermine the Social Security Act's Protections

The Social Security Act expressly exempts Social Security benefits and Supplemental Security Income (SSI) from attachment or garnishment by creditors: “(a) The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and *none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law*” (42 U.S.C. § 407 (a) (emphasis added)).¹ Social Security and other benefit funds remain exempt from attachment, garnishment and related procedures even after they have been deposited into a bank account (*Philpott v. Essex County Welfare Board*, 409 U.S. 413, 416 (1973)).²

Social Security benefits are provided in part to protect recipients from the hardships of existence (*United States v. Silk* 331 U.S. 704, 711 (1947)). Section 407 and related prohibitions against garnishment and other seizures of exempt benefits reflect Congress’ acknowledgement that if these benefits “are to meet the most basic needs of the poor, [they] must be protected from seizure in legal processes against the beneficiary” (H.R.Rep. No. 92-213, 92d Cong., 1st Sess. 156 (1971)). Lower federal courts have recognized that much of the value of these exemptions from legal process resides in their ability to ensure that recipients retain the *uninterrupted* use of their benefits (*See Finberg v. Sullivan*, 634 F.2d 50, 63 (3d Cir. 1980); *Deary v. Guardian Loan Co., Inc.* 534 F.Supp. 1178, 1188 (S.D.N.Y. 1982)). Since these benefit funds often play an essential role in enabling a recipient to meet his or her basic needs, a brief interruption of access to these funds can cause substantial hardships.

Despite this seemingly strong statutory language and judicial interpretation, these protections have been substantially undermined in recent years. Low-income recipients of Social Security, SSI, and other federal benefits routinely discover that their benefit funds, which they believed were safely deposited in a bank account, have been temporarily frozen or, even worse, permanently garnished at the behest of a judgment creditor.³ Creditors with a judgment against a debtor serve a garnishment order, in accordance with state law, which commands a bank to freeze or attach an account holder’s funds. State procedures differ, but most require the bank to freeze these funds for some period of time, during which an account holder may be able to assert that the funds in question are exempt from garnishment under federal law, and as such must be

released. If an exemption is not timely claimed by the benefit recipient, the funds are transferred to the judgment creditor. Unfortunately, as discussed *infra*, account holders often find the process of claiming an exemption—which they may not even know they are legally entitled to—daunting. More immediately, Social Security recipients whose bank accounts are frozen, rendering them incapable of accessing the income they rely upon for subsistence, often experience substantial difficulties during the weeks or even months it may take them to prove the funds are exempt and regain access to their money.

These hardships can occur even when the money in an account is *not* completely removed and transferred to the judgment creditor. In the time that it may take a benefit recipient to challenge an account freeze—the act through which a bank holds funds and restricts an account holder from making a withdrawal—the individual may be unable to pay rent, buy food, or purchase medicine and other necessities. One Social Security recipient, during Congressional testimony, recounted how he and his wife, when their bank account was frozen for 23 days, resorted to living off of a ten-pound bag of brown rice. Waverly Taliaferro lost forty pounds during this period (Taliaferro 2007). Suddenly left without any access to their money, Social Security recipients can find the process of proving their exemptions and obtaining legal counsel daunting, if not impossible. Some individuals, desperate to regain access to their funds, will agree to payment plans with creditors in exchange for the release of a garnishment order, thereby foregoing the exemptions they are entitled to under law (Schultz 2007a).

The total amount of exempt funds that are garnished, that is, completely removed and transferred to a judgment creditor, from benefit recipients' bank accounts is difficult to determine. A July 2008 report by the SSA's Inspector General estimated, based on a representative sample of financial institutions, that the 45.9 million direct deposit Social Security beneficiaries nation-wide had approximately \$177.7 million garnished⁴ over a one-year period (Social Security Administration 2008a). The vast majority, \$171.4 million of this money, was estimated to have been garnished from commingled accounts (accounts containing both exempt benefits and other deposits) (*Id.*). No estimate was offered of what portion of the actual amount taken represented exempt benefit funds. The remaining \$6.3 million in garnishments were estimated to come from accounts containing solely directly deposited Social Security benefits. (*Id.*)⁵ Thirty-seven percent of the financial institutions studied had garnished accounts that

contained only SSA benefit deposits (*Id.*), revealing that the problem was not confined to a small subset of banks.

In the past decade increasing numbers of Social Security, SSD, and SSI beneficiaries have begun receiving their benefits through direct electronic deposit, exacerbating the problem of frozen exempt benefits. In some states, when an account is frozen for a number of weeks or longer, a subsequent check will arrive in the account during the freeze, immediately becoming inaccessible to the recipient. Paper checks can allow a recipient to avoid this danger by choosing not to deposit a newly arrived check into a frozen account.

Federal policy encourages the increased use of direct deposit by benefit recipients. As of June 2008 over eighty percent of SS and SSI recipients receive their benefits electronically (Social Security Online, Direct Deposit, “Trend in Direct Deposit Participation”). The Social Security Administration “strongly encourages all Social Security and SSI beneficiaries to receive their monthly benefits by direct deposit” (Social Security Online, Direct Deposit, “Frequently Asked Questions”). This strong preference reflects a broader federal effort to promote direct electronic deposit (Social Security Administration, 2008a). The active marketing and promotion of electronic payments (and of direct deposit of benefit payments in particular) is an important component of the Treasury Department’s efforts to reduce the costs of issuing payments (Treasury Department 2008).

According to a study sponsored by the Treasury Department, transitioning the remaining approximately 20% of benefit recipients who receive paper checks to electronic payments could save the Department and taxpayers more than \$100 million annually (Treasury Department 2004). It currently costs the Treasury Department approximately 98 cents to issue a paper check, but only 10 cents to issue an electronic payment, for a savings of 88 cents per payment distribution (U.S. Treasury Department 2008). Given that Treasury’s Financial Management Service (FMS) disburses approximately 568 million payments of Social Security and Supplemental Security Income alone each year, the use of electronic deposit, if made universal, would represent a savings of roughly \$500 million each year from the cost of distributing these benefits in paper form (*Id.*).

Although it clearly saves the federal government significant amounts of money, for benefit recipients direct deposit remains both a blessing and a curse. It allows individuals to obtain quicker access to their funds, encourages the utilization of banking services, and enables

beneficiaries to avoid check-cashing fees. Yet, at the same time, direct deposit renders a recipient's money, once it is deposited in a bank account, more readily accessible to judgment creditors and their lawyers. Debt collectors are now able to electronically serve a large number of national banks in hopes of finding an account in the debtor's name at any one of those banks: "Frequently, these demands are mass mailed to banks in circumstances in which the debt collector may not have any reason to believe that a debtor has an account at the institution, or that any such account contains funds that lawfully may be attached" (Comptroller of the Currency 2007).⁶

This and other technological changes have markedly changed the debt collection process (Hunt 2007). Debt collection has become a "growth industry" (*Id.*). At the same time, the market for purchasing difficult to collect consumer debts from creditors has grown. Debt buyers and collection firms, often far removed from the original creditor, flood courts with collection actions. According to a recent study on consumer credit in New York City, the 320,000 consumer debt cases filed in New York City Civil Court in 2006 exceeded by 60% *all* the Civil Court filings in 2001 (Urban Justice Center 2007). As bank regulators have acknowledged, these filings often contain incorrect information, leading to a lack of notice and frequent default judgments against alleged debtors (Comptroller of the Currency 2007).⁷

Although it poses dangers, direct deposit also can prove helpful to debtors, as these deposits—which are electronically coded—render the source of a bank deposit more readily identifiable. This can be especially important in the context of commingled accounts. A commingled bank account contains both exempt benefits and funds from some other, non-exempt source. As discussed more extensively, *infra*, such accounts have been a particular concern for banks, which frequently contend that commingling renders it impossible to distinguish between exempt and non-exempt funds in an account. Advocates for benefit recipients reject this claim and argue that, given the electronic coding of deposits, it would require minimal effort for banks to determine whether the funds in an account are exempt and, if so, to refuse to freeze the account. As a federal district court in New York recently observed, this potential for easier identification of electronic funds, combined with the increased ease with which creditors can serve banks and freeze assets, may demand a reevaluation of whether current state garnishment processes adequately protect the due process rights of benefit recipients (*Mayers v. New York Community Bancorp* (E.D.N.Y. Aug. 31, 2005)).⁸ At the same time,

members of Congress, recognizing the substantial efforts underway to encourage direct deposit, have begun to question whether the government should continue to encourage electronic deposit given the dangers faced by account holders. Senator Herb Kohl, Chair of the Senate Special Committee on Aging, introduced a bill, in April of 2008, which would prohibit the use of Treasury Department and Social Security Administration funds to promote direct deposit of benefits until provisions are in place to adequately protect funds from attachment and garnishment (The Illegal Garnishment Prevention Act (S. 2850)).

The lack of such protections can also diminish consumer trust in banks. This is a particular concern given that efforts to encourage direct deposit, as well as seeking to reduce government costs, strive to encourage benefit recipients to access banking services. As an FDIC representative testified during a Senate Hearing regarding garnishment of exempt benefits: “The adverse publicity and concerns about garnishment can undercut the attractiveness of an insured bank as a place for people to utilize financial services, such as checking, savings and direct deposit. The resolution of this issue is important to the achievement of our broader efforts to encourage consumers to be economically empowered through the banking system” (Federal Deposit Insurance Corporation 2007). Hence a solution to the problem of garnishment can—in addition to furthering Congress’ intended goal in creating these exemptions and protecting individual benefit recipients—also advance efforts to encourage direct deposit and to broaden the utilization of financial services. Given the amount of money at stake, in terms of both government savings from electronic deposit and actual federal benefits, there is a pressing need to craft an adequate federal response to this issue.

This policy paper proposes actions by Congress and the relevant federal agencies to ensure that the protections provided by § 407 of the Social Security Act are not undermined by state law garnishment and attachment procedures. Numerous states have already attempted to strengthen these protections, through legislation and changes in court rules governing garnishments. At the same time, legal actions in federal and state courts have challenged specific state garnishment procedures. These challenges have primarily contended that state procedures violate the due process rights⁹ of benefit recipients and that, by undermining the protections found in federal law, they contravene the supremacy clause of the U.S. Constitution. Under the Supremacy Clause, found in Article VI of the U.S. Constitution, federal laws are

legally superior to any conflicting provision in a state constitution or statute. As such, when there is a conflict between a federal law and a state law, the federal law preempts or supplants the state law, rendering the relevant portion of the state law invalid.

Although state efforts to protect Social Security benefits have achieved some success, the protection of these benefits from garnishment demands a federal solution. Federal law calls for the uniform protection of these benefits, but continued reliance on a patchwork of state regulations will produce inconsistent results. Recipients of Social Security and other exempt federal benefits should not enjoy or be denied the protection of § 407 depending upon their state of residence. As such, there is a need for a federal resolution to this issue, which will further the federal policy goals that underpin the exemption statutes by ensuring consistent protections nationwide.

Any fair and effective resolution must carefully consider the concerns and interests of benefit recipients, banks, creditors, the federal government, and overburdened state and federal courts. This paper carefully reviews the comments and testimony offered by a range of groups regarding both state and federal efforts to address the garnishment issue and offers the following five-part policy proposal:

First, and most simply, the relevant benefit agencies and the Treasury Department must ensure that electronic deposits are clearly and uniformly coded and identifiable as exempt when they arrive in a recipient's bank account.

Second, Congress—not the federal benefit or financial agencies—must implement an automatic exemption system, modeled on that in California, Connecticut, and New York. This system must guarantee that recipients of electronically deposited exempt benefits retain uninterrupted access to a sufficient portion of their funds to ensure their basic needs are met.

Third, Congress should institute a uniform accounting method for resolving issues involving commingled funds. This ensures that benefit recipients are treated equally nationwide and allows banks, creditors, debtors, and when necessary courts to more efficiently and effectively resolve commingling issues.

Fourth, legislation should limit the number of times an account may be frozen and implement a system to ensure compliance with this provision.

Fifth, the proposal calls for both protections for banks that comply with the federal law in good faith and penalties for banks that fail to adequately fulfill their responsibilities, under the new provisions, to examine an account and apply an automatic exemption.

Before presenting this proposal, Part I of this paper examines the attempts by individual states to strengthen protections for Social Security, SSI, and other exempt benefits. This brief study of a few key examples reveals the practical considerations in implementing a solution, the concerns of various stakeholders, and the lessons that can be learned from past efforts. The section concludes by discussing the policies instituted in California, Connecticut, and New York, which provide useful models for a federal response.

Part II shifts to recent discussions of the issue in Congress and among the federal regulatory agencies, particularly those agencies that regulate financial institutions. This analysis focuses on Comments presented in response to a Proposed Guidance by the banking agencies regarding garnishment of exempt funds.

Finally, after considering the efforts in the states, and the concerns of various stakeholders, Part III presents the proposal for a federal policy to protect exempt benefits. It concludes with a brief discussion of bank setoffs and overdraft protection programs.

Part I: State Solutions to the Garnishment Problem Fail to Ensure Consistent Treatment of Federal Benefits, but Do Offer Potential Models for a Federal Response

Administrative Changes in the States, and the Opposition they Have Faced

A number of states have sought to provide stronger protections—from attachment and garnishment—to exempt federal benefits. While nearly all states offer some procedure through which an account holder, after her account is frozen, may raise an exemption and challenge the attachment or garnishment of her funds, certain states have decided that such procedures provide insufficient due process protections or fail to prevent substantial hardships for the benefit recipient during the period of an account freeze. A few states have altered their procedural rules and garnishment forms in order to remedy these perceived deficiencies.

In 2007 the Pennsylvania Supreme Court approved an amendment to the state's Civil Procedure Rules. The amended rules state that a garnishment writ served upon a financial institution "shall not attach any of the defendant's funds on deposit with the bank or other financial institution in an account in which . . . funds are deposited electronically on a recurring basis and are identified as being funds that upon deposit are exempt from execution, levy or attachment under Pennsylvania or federal law" (Pennsylvania Civil Procedure Rule 3111.1 (Effective April 7, 2007)). As Pennsylvania's Civil Procedure Rules Committee has confirmed, this rule protects *all* funds in an account in which any [exempt] funds are deposited electronically on a recurring basis" (Supreme Court of Pennsylvania, 2008). In 2008 the Rules Committee proposed an additional amendment to this provision, which would protect from attachment only the first \$10,000 in a commingled account into which exempt funds are electronically deposited on a recurring basis (*Id.*). Under this newly proposed amendment, if the account holder believes that additional funds are in fact exempt, he or she may assert this exemption. If *all* funds in the account are electronically deposited exempt income, then the garnishment order shall not attach any of the money in the account.

The 2007 amendment also altered Pennsylvania's Writ of Execution form and the rules governing the interrogatories¹⁰ that a garnishee financial institution must answer when they receive an order to attach funds in a bank account.¹¹ The revised "Interrogatories to Garnishee" include two new questions specifically directed towards financial institutions (Pennsylvania Civil Procedure Rule 3253). These interrogatories make the bank responsible for determining whether an account contains identifiable exempt funds "deposited electronically on a recurring basis." If so, the bank must determine what exemptions apply, the amount of funds they apply to, and the entity that electronically deposits the funds. This information must then be included in the answers that the garnishee/bank is required to file within twenty days of being served with the interrogatories.

The Explanatory Comment to Pennsylvania's amended rule states that, prior to the 2007 amendment, the Pennsylvania Rules of Civil Procedure failed to comply with the requirements of federal law, in § 407 of the Social Security Act, protecting benefits (37 Pennsylvania Bulletin 939 (February 24, 2007)). The Pennsylvania amendment seeks to remedy this by requiring banks to determine whether the funds in an account represent exempt benefits and to refuse to

freeze such funds. As the Explanatory Comment states, the defendant benefit recipient no longer must claim the exemption: “Instead the judgment creditor rather than the defendant has the burden of raising an issue with respect to exempt payments . . . [t]he defendant need not file a claim for exemption as exempt funds are not attached” (*Id.*).¹²

Alabama state courts have issued new garnishment forms that inform the garnishee (which would include a bank) that: “Social Security, SSI, VA and federal retirement moneys are all exempt under federal law and remain so even when deposited in a bank or other financial institution. If the only money in your possession or control belonging to the defendant is Social Security, SSI, VA or federal retirement moneys, you should indicate in your answer ‘all such money is exempt from execution’” (State of Alabama 2006). This system, like that in Pennsylvania, requires banks, as garnishees, to examine an account to determine whether it contains exempt funds. However, in contrast with the Pennsylvania protections, in Alabama a garnishee bank is required to refuse an execution order only when “the *only* money” in its possession is exempt. Hence, while the Pennsylvania provision would protect exempt money held in an account containing commingled funds, the Alabama system only protects exempt funds that are not commingled in a bank account with other, non-exempt funds.

Other states have also attempted, through changes in state civil procedure rules and court forms, to require banks to examine accounts and refuse to attach exempt funds. These efforts—in states including Maryland, Virginia, and Nebraska—have faced substantial opposition from state banking associations and have either failed or, in the case of Virginia, briefly succeeded before quickly being reversed. They offer a cautionary tale with regards to attempts to provide protections through the judiciary and on a state-by-state basis.

In 2004 the Virginia Supreme Court amended that state’s garnishment forms. The changed forms required banks to determine whether an account contained exempt funds and, if it contained only direct deposit exempt funds, to refuse to honor a garnishment order (Kuehner-Hebert 2006). After one bank was sued by an account holder for failing to identify exempt funds and refuse a garnishment order, the Virginia Bankers Association campaigned to reverse the amendment, contending in part that the change was not authorized by the relevant statute (*Id.*). In an August 2006 letter to the clerk of the Supreme Court of Virginia, the Association

contended both that the change was not supported by the relevant statute and that it would “create significant new burdens and costs for our banks which we believe the Court may not have appreciated at the time the form changes were authorized.” (Virginia Bankers Association 2006). In particular, the Association claimed that the prevalence of commingled funds would render it “time-consuming and difficult to determine whether or not funds in an account consist “solely” of direct deposited federal benefits.” In addition to these administrative considerations, the Association expressed concern, exacerbated by its belief that the changed forms were not authorized by the statutory language, that judgment creditors would raise claims against banks, contesting whether the money in an account is exempt and creating liability for the banks (*Id.*).

The Supreme Court of Virginia responded to the Virginia Bankers Association’s efforts by revising the relevant forms and removing the statement regarding federal exemptions from garnishment. In a letter to the Association confirming these changes, the Court’s Executive Secretary stated that the modifications were due to “an inconsistency between the garnishment summons and the [state] statutory form” and “the potential for misreading the statement as creating an obligation for banks that does not otherwise exist” (Supreme Court of Virginia 2007).

In October 2006 a similar amendment, also requiring banks to examine accounts for exempt funds, was proposed to the Maryland state courts’ Standing Committee on Rules of Practice and Procedure (Maryland Legal Aid Bureau 2006). The Maryland Banker’s Association (MBA) responded to these proposed amendments, echoing many of the concerns raised by the Virginia Bankers Association (Maryland Bankers Association 2006).¹³ In subsequent written comments the MBA questioned the judiciary’s power to require banks to assert an exemption on behalf of their depositors (Maryland Bankers Association 2007).

The Judgments Subcommittee of the Maryland Rules Committee attempted to alleviate the additional concern that the proposed rule would impede the attachment of non-exempt funds by altering the amendment’s language to confine its application to accounts that contained *only* exempt funds, a system akin to that in Alabama (Maryland Court of Appeals 2007). Nonetheless, the full Rules Committee ultimately decided that the matter was beyond the scope of its authority and should be decided instead by the state’s legislature (*Id.*).¹⁴

These experiences at the state level are informative. The state bankers associations in Virginia and Maryland voiced concerns that have been routinely expressed by banks and banking

associations in their comments regarding the proposed federal agency guidance on the garnishment of exempt funds. While the provisions in Pennsylvania and Alabama provide some protection for exempt funds, the events in Virginia and Maryland indicate that a legislative response, rather than a change sought through the judiciary or an administrative agency, might provide the most effective solution. Three other states, California, Connecticut, and New York, have responded to the garnishment problem with legislation.

Statutory Solutions in California, Connecticut, and New York: Possible Models for Action?

California, Connecticut and New York have each instituted laws to protect exempt benefits held in bank accounts.¹⁵ The defining feature of these three policies is their requirement that a bank, upon receiving a garnishment order, must review an account to determine if it receives directly deposited exempt funds and, if it does receive such funds, automatically leave a fixed of money in the account and freeze only the funds that exceed this amount. For the sake of clarity these provisions, which do not require any action on the part of a benefit recipient to be effectuated, will be referred to collectively as “automatic exemptions” for the remainder of this paper.

These provisions differ in their details, but each protects a set amount of funds in any bank account into which exempt benefits are electronically deposited. Under the Connecticut statute a financial institution served with a garnishment order must leave the lesser of the account balance or \$1,000 in any account into which “electronic direct deposits that are readily identifiable as exempt” have been deposited during the prior thirty-day period (Connecticut General Statutes §52-367b). In New York the first \$2,500 in a judgment debtor’s account into which “direct deposit or electronic payments identifiable as statutorily exempt payments were made” during the prior forty-five days is protected (New York Exempt Income Protection Act (A08527A/S6203B)).

The California provision provides similar protections to any account in which social security benefits or public benefits are directly deposited. These accounts are exempt, without the account holder claiming an exemption, in varying amounts depending on whether the depositor receives public benefits or social security and whether either one or two or more depositors are the designated recipients of the benefits payments. (California Code of Civil Procedure §704.080).¹⁶ Currently, an account in which “one depositor is the designated payee of

directly deposited social security payments” is automatically exempt in the amount of \$2,700 (California Administrative Office of the Courts 2007).

Each of these state systems provides a procedure through which an account holder may assert an exemption from garnishment for funds in the account that exceed the automatic exemption. This ensures that benefit recipients retain control of some amount of their funds while they raise a challenge to the garnishment of the remainder of their accounts. This protection not only enables benefit recipients to continue paying for rent, food, medical expenses and other necessities, but also provides recipients with access to funds that may enable them to assert their exemptions and challenge the garnishment order.

These provisions also attempt to clarify and expedite the court procedures for judicial determinations of whether additional funds are exempt. The New York act seeks, when possible, to have the matter resolved by the judgment debtor, the judgment creditor, and the bank without requiring a court hearing. The Association of the Bar of the City of New York has predicted that these new procedures for resolving exemption questions will mean “that most disputes will end without resort to an already overburdened court system” (Association of the Bar of the City of New York 2008). Similar concerns regarding “the efficient use of judicial resources” represent a central factor courts have considered in evaluating how well a state’s debt collection procedures protect a debtor’s due process rights (*McCahey v. L.P. Investors*, 774 F.2d 543, 549 (2d Cir. 1985)).

In New York, if the judgment debtor claims that additional funds are exempt, and the judgment creditor does not object—through an affidavit that demonstrates a reasonable belief that the account contains non-exempt funds—the bank must release the remaining funds to the judgment debtor within eight days of receiving the exemption claim form (NY Bill A08527/S6203 (new CPLR 5222-a(c)(2)). If there is an objection the bill delineates an expedited procedure through which the court will determine whether funds are exempt (*Id.* (new CPLR 5222-a(d)). The bill also provides additional protections for a judgment debtor, which enable her to counterclaim against a judgment creditor if the creditor’s objection is raised in bad faith or the creditor possesses actual knowledge that the funds in question are exempt (*Id.* (new CPLR 5222-a(g)).

As is discussed in greater detail below, a federal policy should not outline a procedure for resolving exemption claims in relation to additional funds; this remains a proper object of state

law and judicial rulemaking. Nonetheless, in creating an automatic exemption, Congress should consider the procedures states might apply in deciding additional exemption claims. These procedures will affect how long an individual might lack access to these remaining funds while they assert any additional exemption claim. The particulars of the California, Connecticut, and New York provisions are presented in more detail in the Appendix.

Part Two: Federal Responses and the Need for Congressional Action

Senate Finance Committee Hearing

In September 2007, the Senate Finance Committee held a hearing entitled “Frozen Out: A Review of Bank Treatment of Social Security Benefits.”¹⁷ The hearing occurred on the day after federal banking regulators issued a Proposed Guidance for banks regarding how they should respond to state court orders to freeze accounts that contain exempt federal benefits.¹⁸ Finance Committee Chairman Baucus expressed his disappointment with the Proposed Guidance, contending that it failed to adequately acknowledge the supremacy of federal law over state court procedure. He also strongly asserted that federal law bans the garnishment or freeze of social security and other protected funds (Baucus 2007). The federal regulatory agencies, particularly the Federal Deposit Insurance Corporation (FDIC), challenged this position in their written statements and oral testimony. They contended that, rather than bar the freezing and garnishment of benefits, the exemption in § 407 of the Social Security Act merely provides an affirmative defense, which a judgment debtor may raise (FDIC 2007). The FDIC and the Office of the Comptroller of the Currency both testified that the Social Security and Veterans Administration had each interpreted the garnishment exemptions in their governing statutes as an affirmative defense to be raised after a freeze, rather than a bar on the initial imposition of a freeze or hold (*Id*; Comptroller of the Currency 2007).¹⁹ Voicing a similar sentiment, the Office of Thrift Supervision, in its own testimony, argued that “[f]ederal laws protecting benefits from garnishment do not specifically prohibit a financial institution from freezing an individual’s account during the period when a garnishment order is challenged by the recipient of the federal benefits” (Office of Thrift Supervision 2007). The Supreme Court has read this provision quite differently, stating that § 407 “imposes a *broad bar* against the use of any legal process to reach

all social security benefits” (*Philpott v. Essex County Welfare Bd.* 409 U.S. 413, 417 (1973)).

Proposed Guidance Issued by the Federal Banking Agencies and Subsequent Comments

As mentioned, the federal banking agencies (Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration) issued a notice and call for comments on September 28, 2007 regarding the Proposed Guidance on Garnishment of Exempt Federal Benefit Funds. Rather than issue firm requirements, through regulations binding on the banks, the Proposed Guidance offered a set of best practices “to encourage financial institutions to have policies and procedures in place with respect to handling garnishment orders” (Federal Register 2007). These practices included, among others: providing consumers with information regarding which federal benefits are exempt; promptly determining whether an account contains only exempt benefit funds and, if state law permits, refusing a freeze order in such instances; and allowing a consumer access to an amount equivalent to the exempt federal benefits.

Banks Contend that Examining Accounts for Exempt Benefits is too Difficult

Banks had mixed feelings in response to these words of encouragement. Although there were some variations in the comments offered by financial institutions and the relevant trade associations, a number of these comments contended that the Proposed Guidance, particularly the call to identify exempt benefits in an account, was impractical, if not impossible, for banks to implement. Capital One stated that “it is not possible to reliably identify the exempt status of incoming deposits, nor is it possible to reliably identify what amount of a deposit account constitutes exempt federal benefit funds” (Capital One Financial Corporation 2007). Bank of America, noting that the over ninety percent of its accounts that regularly receive federal benefits also received deposits from other sources, contended that a proposal requiring banks to identify and protect accounts that contain *only* exempt benefits would demand a “staggering” effort on the bank’s part, but provide “minimal” benefits to consumers (Bank of America 2007). The Consumer Banker’s Association offered a similarly frank assessment of the perceived challenges in identifying exempt funds: “Many of what appear to be primary assumptions underlying the practices suggested in the Guidance are flawed and present infeasible or impossible operational challenges” (Consumer Banker’s Association 2007).

These assertions are undermined by statements made by several banks that already voluntarily examine accounts for exempt funds and, where appropriate, refuse to freeze an account. One of the nation's largest financial institutions, JP Morgan Chase, in its comments on the Proposed Guidance, stated: "when Chase identifies an account in the name of the judgment debtor that appears to have received *only* direct deposits of exempt federal benefits over the previous 90 days, we generally notify the judgment creditor or its representative that we have not placed a freeze on the account because it appears to contain only exempt federal benefits" (JP Morgan Chase 2007).²⁰ JP Morgan Chase agreed with the Proposed Guidance's recommendation that banks promptly determine whether an account contains exempt benefits, suggesting, however, that the recommendation "be clarified to require reasonable efforts to identify direct deposits of federal benefit funds, but not check deposits of such funds" (*Id.*) A number of other banks have also acknowledged that they already investigate and identify directly deposited exempt funds and refuse to freeze accounts containing only such funds. These include New York Community Bank, Astoria Federal Savings, Banco Popular, and Citibank (South Brooklyn Legal Services 2007).

Advocates on behalf of social security recipients have strongly challenged banks' claims regarding the difficulty of identifying exempt funds in an account. AARP, in its comments on the Proposed Guidance, contended that ". . . deposits solely consisting of federally exempt funds are easily identifiable because the source of the deposit is clearly marked as Federal funds. Additionally, Federal benefit payments only increase once a year and the same amount is deposited each month to a recipient's account. If banks review the record of deposits to the account over the course of 90 days, they can easily identify which accounts only contain exempt funds as those deposits are usually made once a month and are designated as Federal funds" (AARP 2007).

Echoing some of these sentiments, the Social Security Administration, in testimony nearly a decade ago regarding its efforts to encourage direct deposit, stated: "Direct deposit significantly improves payment delivery services. There is an electronic audit trail to ensure that the payment can always be located. Payments can be traced through the banking system and beneficiaries have a permanent record of their payment through their bank records" (Social Security Administration 1999).

Part III: Policy Proposal

Step One: Standardize ACH Coding of Electronic Benefits

Consumer advocates and bank representatives dispute whether it is easy, under current conditions, for a bank to determine if directly deposited funds are benefits exempt from garnishment. The American Bankers Association, in its comments on the Proposed Guidance, argued that it is difficult for a bank to identify exempt benefit payments. Although electronic payments—which are disbursed through the Automated Clearing House (ACH) system—*may* include a code that identifies the sender and type of payment, the Association contends that the payers of exempt benefits are not required to “consistently and correctly” use standardized payment descriptions (American Bankers Association 2007). In order to rely on a program that would read such coding, the Association alleges, “all senders of exempt payments must adopt and use consistently a standardized batch header code that clearly identifies a payment as exempt and inform all depository institutions which codes apply to which exempt funds” (*Id.*). In a separate letter to the Social Security Administration, the ABA insisted that establishing distinctive ACH codes, in addition to ensuring the use of uniform descriptors, would allow easier identification by bank deposit systems, eliminating the need for manual review (American Bankers Association 2008).

In a similar vein, the Community Banker’s Association contended in its comments on the Proposed Guidance that “While codes currently exist to identify [benefit] payments, they lack the clarity needed to create the fully operational automated systems that are necessary to handle the extensive volume of garnishments received by financial institutions” (Consumer Bankers Association 2007). In their separate comments on the Proposed Guidance other trade associations and individual banks made similar appeals for standardized coding of electronic deposits and specific codes to identify exempt funds.²¹

Regardless of whether identifying exempt electronic benefits is or is not an easy task, the Treasury Department and the relevant benefit agencies (Social Security, Veterans Administration) should clarify both the descriptors and the ACH coding for direct deposits of exempt benefits. In addition to identifying the type of benefit these codes should identify the funds as exempt and, as will be discussed below, the number of recipients entitled to a specific benefit (a particular concern in the context of survivor benefits). Improved coding can also, as

some banks have indicated, allow for greater automation and hence streamline the processing of garnishment orders and the application of an automatic exemption system.

Step Two: Institute an Automatic Exemption—of a Set Multiple of the Exempt Benefit—for
Accounts that Receive Electronically Deposited Exempt Federal Benefits

An automatic exemption system provides a number of advantages over a system—like that in the Proposed Guidance and some states—that would require banks to examine an account and refuse to freeze an amount equivalent to only the exempt benefits. An automatic exemption system would be easier to apply, likely leading to more rapid and consistent compliance. It would ensure that recipients' benefits are not interrupted while a bank determines what portion of an account is exempt. At the same time, it would avoid the potential difficulties caused by accounting errors on the part of a financial institution attempting to determine what portion of an account is exempt. Finally, it would make it easier for regulators to monitor bank compliance.

In their comments on the Proposed Guidance, a number of banks and banking associations supported an approach similar to that of California, Connecticut, and New York. In advocating for the Connecticut law, the American Bankers Association stated: “This approach enables the customer to have access to funds to live on while the dispute is resolved, and it provides a comparatively simple, clear rule that provides the bank with the protection that it needs. Such an approach, adopted at the federal level and preempting inconsistent state laws, would be a more effective way to strike the appropriate balance between the rights of creditors and debtors, respectively, while building on those steps that banks can actually take to play a constructive role” (American Bankers Association 2007). Bank of America expressed similar sentiments regarding the California model, noting that it simplified the required research and allowed banks to avoid determining the status of commingled funds (Bank of America 2007). JP Morgan Chase, which, as previously noted, voluntarily examines accounts for exempt benefits and refuses an order to freeze or garnish accounts containing only exempt funds, also endorsed an approach like the California and Connecticut statutes (JP Morgan Chase 2007). Chase contended that the federal benefit agencies, including the Social Security Administration, could

implement a similar system through preemptive regulations and expressed its support for such regulations.

Congress, Rather than the Agencies, Must Establish the Automatic Exemption

It is not clear, however, that the benefit agencies—or federal agencies in general—are the proper entities to institute such a system. Agency regulatory actions must conform to the particular authority granted to the agency by its governing statute. When an agency’s interpretation of the statute it administers is challenged in court, the courts apply the deferential standard of review delineated by the Supreme Court in *Chevron v. Natural Resources Defense Council*, 467 US 837 (1984). The two-step *Chevron* review first asks whether Congress spoke directly to the precise question at issue. If Congress’ intent is unambiguous the court and agency must effectuate this intent. There is then no need to move to step two. But, when Congress has not clearly addressed the relevant issue—the statute is either silent or ambiguous on the issue—the court must ask “whether the agency’s answer is based on a permissible construction of the statute” (*Id.*). A court must defer to an agency’s regulation, even if the court itself would have interpreted the relevant statute differently, so long as that regulation is not “arbitrary, capricious, or manifestly contrary to the statute” (*Id.*).

According to the federal banking agencies, in their Congressional testimony, the Social Security Administration has interpreted the protections from attachment and garnishment found in § 407 of the Social Security Act as affirmative defenses, to be raised by a benefit recipient, rather than absolute bars that prohibit outright any act of attaching or freezing a bank account containing benefits. The Social Security Administration’s own literature and website also indicate that this appears to be the agency’s reading of the statute. This interpretation of the statute, which itself does not specify how the protections it establishes are to be implemented, satisfies the deferential standard of review articulated by *Chevron*. At the same time, it very likely that, if the Social Security Administration were to change its interpretation and state that § 407 absolutely bars any action to attach or garnish an account, this too would be found to be a “permissible construction of the statute.” Both interpretations, and any formal regulations that implement them, simply represent an agency’s policy decision regarding the best way in which to effectuate Congress’ intent to protect exempt benefit funds from attachment, garnishment, and other legal procedures. Ensuring that banks themselves examine accounts and refuse an order to

freeze properly exempt benefit funds might require further regulations by the federal banking agencies. Still, a solution of this kind could be implemented through joint action by the benefit and banking agencies and without any action by Congress.

In contrast, a protection like that provided in California, Connecticut, and New York could not properly be implemented through agency action. Rather than simply ensuring the protection of exempt benefit funds and only those funds, these solutions create a new exemption, which often may extend to money that would not otherwise be exempt. These state solutions define a specific amount of money that will be automatically protected from attachment and garnishment, regardless of its source, so long as it is in an account that contains electronically deposited exempt funds. In doing so these state statutes have created a protection that goes beyond that provided by § 407 of the SSA and the analogous federal benefit statutes. Although, as discussed earlier, Congress' intent in providing the protections in § 407 included ensuring that benefit recipients retain the funds needed for a subsistence living, and the state solutions further this underlying goal, the federal statutes seek to pursue this goal in a specific way, by exempting particular federal benefits from collection. If a solution similar to that in California, Connecticut and New York were to be attempted through agency regulation such regulation could be successfully challenged as going beyond a "permissible construction" of the relevant statutes. More likely, such agency action could simply be challenged as *ultra vires*—beyond the scope of the power conferred to the agencies by their governing statute. As such it would be in danger of being declared invalid.²²

These concerns perhaps underlie the reactions of the federal benefit and banking agencies to calls for regulation to solve the garnishment issue. In its testimony before the Senate Finance Committee the FDIC argued that, while they are working to address concerns about protecting exempt funds, "the FDIC and other bank regulators currently lack adequate legal authority to effectuate a comprehensive solution to the issues raised by garnishment" (FDIC 2007). At the same time, however, the Social Security Administration has concluded that, while the language of § 407 of the Social Security Act is clear, it "does not provide us with any means for enforcement and does not establish any penalties for its violation" (Social Security Administration 2008c). These statements might reveal mere reluctance on the part of individual agencies to engage in the challenging task of crafting an adequate solution, coupled with a desire to push the issue into the realm of a different agency.

A separate legal concern is raised in the area of federal agency regulations and their preemption of state law. The courts have not definitively answered the question of whether the federal statutes providing exemptions for benefits preempt most state garnishment procedures. Although a properly promulgated agency regulation will preempt a conflicting state law, it is not clear whether an agency's interpretation of the preemptive effect of its own regulations, or of a particular statute, is entitled to deference by the courts (Quester and Keest 2008). Justice Stevens, dissenting in *Watters v. Wachovia*, discussed this issue, which the majority opinion avoided: should an agency be given deference when it purports to settle a question of federal preemption of state law? (*Watters v. Wachovia* 550 U.S. ____ (2007)) Stevens declared that such deference would be misplaced, in part because agencies, unlike Congress, do not adequately represent the interests of the states whose laws they may preempt.²³

These considerations—coupled with the complex interplay of laws governing public benefits, banking, debt collection, and state procedures—argue in favor of Congressional action to resolve this issue. Only such action can ensure that the policy goals that compelled Congress to institute § 407 and similar provisions are adequately effectuated *and* the interests of benefits recipients, creditors, banks, and state and federal courts are properly balanced.

Determining the Proper Size of an Automatic Exemption

Setting the proper monetary amount for an automatic exemption requires consideration of factors including: the length of time it takes to establish whether remaining funds are exempt from collection and a freeze should be lifted, the size of benefit payments, the amount of money benefit recipients need to provide for their basic needs over a set period of time, and a consideration of the rights of creditors to non-exempt funds that might be in the account.

States vary in the procedures through which benefit recipients challenge a garnishment order and claim additional exemptions. The California, Connecticut, and New York automatic exemption statutes each provide procedures for an account holder to assert exemptions in relation to any money in the account that exceeds the automatic statutory exemption (*See* Appendix). In Connecticut these remaining funds are restrained until a court order is issued, or at the end of 45 days. New York offers a more streamlined system, through which funds should be released within a maximum of 30 days. Given the very real possibility of delay, including a delay on the part of a bank or the judgment creditor in releasing an account, it would be

reasonable to institute an automatic exemption that would provide sufficient funds for an individual to survive 45 days without access to his or her account. It must be remembered that, once an account receives a garnishment order, any subsequent direct deposits—beyond the automatic exemption amount—will remain frozen.

The size of a recipient’s exempt benefits can vary dramatically. As the table below reveals, for SSI and Social Security alone an individual’s benefits may range from \$637 for an SSI recipient to a maximum of \$2,185 monthly for some Social Security recipients. This variance might appear to render the establishment of a constant automatic exemption amount rather arbitrary. The task might be simplified by focusing on the purpose of the § 407 exemption, ensuring the resources necessary to meet basic needs (which the poverty guidelines in the table below might be deemed to represent). At the same time, if the automatic exemption is to further the express goals of § 407 (protecting exempt benefits themselves) it should at least protect the amount of an average Social Security benefit received during the maximum potential length of a freeze. The 45 day period discussed above would represent roughly 1.5 months. Taking the benefit of an average retired worker (\$1,081) and multiplying it by this period yields \$1,621. Given that an individual might have additional exempt money in the account, and also might need to obtain the services of an attorney or incur other costs in relation to raising this exemption, it would be reasonable to protect additional funds for this purpose. For the sake of clarity \$2,000 might represent a reasonable amount for a national automatic exemption.

| <u>Social Security and Supplemental Security Income Monthly Benefit Amounts</u> | |
|---|---------|
| Average Benefit – Individual Retired Worker | \$1,081 |
| Average Benefit – Individual Disabled Worker | \$1,004 |
| Average Benefit – Widowed Mother with two children | \$2,226 |
| Average Benefit – Disabled worker, young spouse, and one or more children | \$1,681 |
| Supplemental Security Income, Individual Recipient | \$637 |
| Maximum Monthly Social Security Benefit | \$2,185 |
| <i>Department of Health and Human Services Individual Poverty Guideline</i> | \$867 |

Sources: Lavery 2008; Social Security Administration 2008b; Department of Health and Human Services 2008.

This amount should serve to ensure that a recipient will have the funds necessary to live for up to 45 days without access to her funds. At the same time, because it is not too high, it also

makes it possible that non-exempt funds in an account will remain frozen, allowing a judgment creditor access to these funds.

Survivor benefits, which may be paid to multiple people, can complicate this picture. A widow with two children receives an average benefit of \$2,226. Hence a \$2,000 automatic exemption would not protect an equivalent amount of money for a 45 day period. California's statute, which establishes different sizes of automatic exemptions depending on the number of designated payees, provides a possible solution to this concern. Changes in ACH coding could take the possibility of multiple beneficiaries into account and ensure that new codes indicate the number of payees receiving a specific benefit payment.

Although California, Connecticut, and New York have focused on a fixed amount for an automatic exemption (with some variations in the California system), this is not the only viable approach. Given the concerns just discussed, a better approach would protect a set multiple of the actual benefits electronically deposited into a given account. Congress should require banks to, upon determining that an account contains directly deposited exempt funds, also determine the amount of these deposits. Banks should be required to then refuse to freeze a certain multiple—perhaps 1.5 or 2 times—of the amount of the last direct deposit of exempt funds. This would allow the size of this protection to take into account differences in the amount of exempt benefits received.

Step Three: Clarify How Commingled Funds Should Be Treated

Federal and state courts, when confronted with the issue of commingled funds, have applied various accounting methods to determine how much of an account is exempt from garnishment and how much a judgment debtor can assert a right to garnish. These inconsistencies cause confusion and determining the proper method to apply can delay resolution of claims. Any new policy should require the applications of a specific accounting method—First in, First out—for determining the status of commingled funds. This approach has been embraced by the majority of courts and would be the easiest to administer.

First in, First out Accounting

Many courts have applied the “first in, first out” rule of accounting, which is based in common law and codified in the Uniform Commercial Code (UCC § 4-210(b)). This method is

also used by the Connecticut automatic exemption statute for determining the status of any funds beyond the \$1,000 automatic exemption. When this system is applied the funds in an account are deemed to be withdrawn in the exact order in which they were deposited. Under this method an account “will be completely exempt if the current balance is equal to or less than the last direct deposit and no subsequent deposits were made” (South Brooklyn Legal Services 2007). The following table represents how this accounting system works. This example assumes a jurisdiction without an automatic exemption, but this same accounting also could be applied, if such a system were in place, to the excess money above the automatic statutory exemption.

| Transaction | Deposit | Withdrawal | Exempt Funds in Account | Non-Exempt Funds in Account | Total Account Balance |
|-------------|------------------|------------|-------------------------|-----------------------------|-----------------------|
| 1 | \$500 exempt | | \$500 | | |
| 2 | \$200 not exempt | | 500 | \$200 | \$700 |
| 3 | | \$300 | \$200 | \$200 | \$400 |
| 4 | \$500 exempt | | \$700 | \$200 | \$900 |
| 5 | \$100 not exempt | | \$700 | \$300 | \$1,000 |
| 6 | | \$400 | \$500 | \$100 | \$600 |

Source: author’s calculations.

In this simplified example the initial deposit, of \$500 in exempt funds, is the first in the account. The withdrawals then count against this deposit until it is exhausted. At that point they begin to reduce the second deposit, of \$200 in non-exempt funds. This example may seem overly simplistic, given it involves only six transactions. However, this method can also be used with any account to track money going backwards. We merely look at the total balance on the last day, here \$600, and add the deposits going backwards in time until we have total deposits that equal this total balance. In this case this would be satisfied by the last two deposits (transactions 4 and 5). These deposits represent the amount of exempt funds and non-exempt funds that remain in the account using a “first in, first out” accounting method: \$500 and \$100 respectively.

Although it offers valuable clarity, this accounting system can lead to potentially disparate results in quite similar situations. For instance, using the example above, if this account was garnished immediately after the \$300 withdrawal (transaction 3), that entire

withdrawal would count against the exempt funds, leaving an individual with \$400 in the account, only half of which, at the time of garnishment, is exempt. If we change the example, and switch the order of the first two transactions, so that the \$200 in non-exempt funds is deposited before the \$500 in exempt funds, this situation changes dramatically. Now the withdrawal counts against \$200 in non-exempt funds and only \$100 in exempt funds. If the account is frozen after the third transaction the account holder will be able to claim an exemption for all \$400 in the account, leaving the judgment creditor with nothing.

Such a system might be considered inequitable as a judgment creditor would appear to face substantially different liability depending on the vagaries of time, including whether she made a deposit of non-exempt funds before or after her last direct deposit of exempt benefits or when a garnishment order was served in relation to her last direct deposit of exempt benefits. Given the strong federal interest in protecting exempt benefits from garnishment it would seem that accounting for commingled funds should not depend upon such seemingly arbitrary timing issues. However, given that such examples are likely to be rare (and potentially have less of an impact on account holders already benefiting from an automatic exemption), and that the first in, first out method is substantially easier to apply than other accounting methods, it represents the best choice for resolving commingled funds.

Lowest Intermediate Balance Accounting

Under the New York legislation, when the funds beyond the exemption are commingled, a judgment creditor, after receiving from the debtor an exemption claim form and proof of exemption, must apply the lowest intermediate balance principle of accounting and then instruct the bank to release any exempt money. The lowest intermediate balance principle is borrowed from the law of trusts. (*See* Restatement (Second) of Trusts §202 (1959)).²⁴ Under this rule, the amount of a traced deposit that remains in an account is equal to either the full amount of the deposit itself or the lowest balance in the account at any time between the deposit and the present (whichever is lower). If you are tracing a \$200 deposit of exempt funds, and the account has never fallen below \$200 since the deposit was made, then the full \$200 is considered to still be in the account. However, if the account dropped to \$50 and is now at \$150 due to subsequent deposits of other funds, then the amount of the traceable funds in the account is only the “lowest intermediate balance,” which is \$50. This method is clear in this example, but would involve too

much complication in the context of a commingled account featuring multiple exempt and non-exempt deposits. Moreover, the New York law does not explain precisely how it is to be applied in the context of exempt funds, particularly when those funds exceed the automatic exemption and therefore likely represent multiple benefit payments. The complexity of applying the lowest intermediate balance rule, and the possibility of confusion or accounting problems, provides further support for choosing the first in, first out method.

Step Four: Limit the number of times an account may be frozen

In some states, including New York, it is easy and costless for a creditor to issue a restraining notice on a bank and freeze an account (Urban Justice Center 2007).²⁵ An account can be restrained multiple times in a single year by a judgment creditor, causing hardship to both benefit recipients and the financial institutions that must process these restraints. To partially remedy this, the New York automatic exemption legislation provides that a judgment creditor may serve a bank account with no more than two restraining notices in a single year (Calabrese and Keefe 2008). Connecticut's statute limits the number of restraints by requiring that a party seeking to execute a garnishment order apply to a court and pay a \$35 fee, which can be recovered from the debtor.

A federal policy could help solve the problem of multiple garnishments by imposing a fine or other penalty on judgment creditors who repeatedly serve a restraining notice on the same bank account after being informed that the account contains only exempt funds. Another possible solution would be to require these judgment creditors to file an affidavit offering a reasonable basis to believe that the account contains non-exempt funds. Ohio state law formerly required an affidavit of this sort for any garnishment of property to be commenced.²⁶ The affidavit, signed by the judgment creditor or his attorney, was required to state "[t]hat the affiant has a reasonable basis to believe that the person named in the affidavit as the garnishee may have property, other than personal earnings, of the judgment debtor that is not exempt under the law of this state or the United States" (Ohio Rev.Code Ann. § 2716.11).

Given the potential difficulty with policing a fine system, the most effective solution would be to require banks to simply flag accounts as exempt the first time an automatic exemption is applied. The bank should mark an account as exempt and automatically return as unenforceable any subsequent garnishment order. If a collector subsequently wishes to serve a

new garnishment order, and to allege that the funds in the account have changed sufficiently to justify a new collection attempt, they must then complete an appropriate affidavit and receive permission from a court to issue such an order.

Step Five: Protect banks and hold them liable

Protecting Banks from Liability

When they receive a court order to attach or garnish an individual's bank account, banks find themselves caught between the requirements of federal laws that exempt benefits from attachment and state laws that threaten to hold banks in contempt or financially liable for failing to attach an account (Independent Community Bankers of America 2007). A bank that fails to prevent an account holder from withdrawing funds, after the bank has received a garnishment order, may, in certain states, be held financially liable for the value of the judgment (American Bankers Association 2007). However, it is unclear whether these penalties apply to a bank that refuses to attach exempt funds or whether any bank has ever been subject to a penalty for such a refusal (National Consumer Law Center 2007). In some states—although the garnishment statute declares that banks will be held liable for failing to freeze an account—the state's garnishment forms require a bank to indicate in its answer that an account contains only exempt funds and to refuse to freeze this money.²⁷ In the light of such ambiguity it is understandable that banks would be reluctant to refuse an order to attach an account.

Although there is a dispute regarding whether banks face legal and financial liability for refusing to freeze exempt funds, the banking community has expressed strong interest in protection from liability.²⁸ Given its preemptive power, a federal law mandating that banks review accounts for electronically deposited exempt benefits and refuse to freeze such funds should automatically protect banks that follow it. Nonetheless, it would be reasonable to include in federal legislation a provision similar to that found in the Connecticut statute. The Connecticut law protects a bank from liability to the judgment creditor if the bank, acting upon the good faith belief that the account received "readily identifiable" exempt benefits, failed to freeze the \$1,000 protected under the statute (Connecticut General Statutes §52-367b(n)).

In their comments on the proposed garnishment regulations, members of the banking community expressed their desire for a safe harbor that would protect banks from liability—to

either the judgment creditor or the account holder—if they wrongfully interpreted or applied an exemption (Financial Services Roundtable 2007; Compass Bank 2007; Huntington Bank 2007). There remains, however, a potential danger in providing too generous a safe harbor, particularly if it extends protection from both the judgment creditor and the account holder. Absent careful oversight, banks might rely on the safe harbor and fail to adequately review accounts for exempt funds. Given a federal policy, as articulated by this proposal, that mandates clear, standardized ACH coding, banks should have no problem ascertaining whether exempt funds are electronically deposited into an account, rendering a safe harbor practically unnecessary.

Banks should be held liable to account holders for not applying an automatic exemption

Once Congress has instituted a clear federal policy providing an automatic exemption—and the benefit agencies and Treasury Department have ensured that ACH coding clearly identifies exempt funds—banks should be held accountable for failing to comply with this law. An automatic exemption system will only be effective to the extent that banks act in accordance with its requirements. A federal policy, implemented in part by the federal financial services regulators, could ensure such compliance through monitoring and fines. Congress might also provide for a private right of action enabling individual benefit recipients to bring claims against banks that fail to comply. An effective enforcement strategy will be essential to ensuring that an automatic exemption system protects Social Security recipient’s benefits.

A final comment on bank setoffs and overdraft protection programs

Bank setoffs, through which a bank removes money from an account in order to pay off an outstanding debt the account holder has with the bank, raises additional concerns for recipients of exempt benefits.²⁹ Banks have contended that, because they do not need to go to court in order to setoff an account (often their actions conform to an agreement signed by the account holder), the practice does not represent an “other legal practice” within the scope of § 407.³⁰ In what is perhaps the leading case on the issue, the Tenth Circuit rejected this view. The court declared: “We can see no reason why Congress would, on the one hand, choose to protect Social Security beneficiaries from creditors who utilized the judicial system, a system that is built upon principles of fairness and protection of the rights of litigants, yet, on the other hand, leave such beneficiaries exposed to creditors who devised their own extra-judicial methods of collecting

debts” (*Tom v. First American Credit Union*, 151 F.3d 1289 (10th Cir. 1998)).³¹ In its analysis of § 407 the Tenth Circuit discussed a decision by the California Supreme Court, regarding a bank’s attempt to setoff funds exempt under California law. That decision also rejected any distinction between setoff and garnishment: “The assertion of a banker's setoff has exactly the same effect as a third party's levy of execution on the account—it deprives the depositor of the income which the state provided him to meet subsistence expenses, compelling the state either to give him additional money or leave him without means of physical survival” (*Kruger v. Wells Fargo Bank*, 11 Cal.3d 352 (1974)).

These cases offer sound legal analysis grounded in the legislative intent that animated the establishment of these exemptions. Congress, when amending the Social Security Act to clarify and strengthen the protections provided by § 407, must also ensure that these changes specify that benefit funds are also exempt from setoff by banks. As AARP and the National Senior Citizen’s Law Center both noted in their comments on the Proposed Guidelines, there is an urgent need to protect recipients from the efforts of financial institutions to seize their exempt funds (National Senior Citizen’s Law Center 2007; AARP 2007).

In addition to the problems raised by setoffs, a somewhat separate legal issue is raised by what are termed “overdraft protection loans” (Schultz 2007b). This system provides account holders with short term loans, typically provided with fees of approximately \$20 or \$30, to cover overdrafts. The bank then repays itself from the account once sufficient funds (whether exempt or otherwise) are deposited (*Id.*). In *Lopez v. Washington Mutual*, the Ninth Circuit addressed a claim that this system represented garnishment of exempt benefits through an “other legal process” prohibited by § 407 (*Lopez v. Washington Mutual*, 302 F.3d 900 (9th Cir. 2002)). The court held that the overdraft system at issue was valid under § 407, in part because the plaintiffs voluntarily agreed to the system, rendering each deposit into the account a voluntary payment of their outstanding debt. The *Lopez* court also tried, arguably unsuccessfully, to distinguish the decision in *Tom* on the grounds that the set-off in *Tom* applied to a distinct debt, while the overdraft program in *Lopez* related to the functioning of the specific account into which the money was deposited.

These overdraft protection programs can divert substantial sums of exempt benefits from account holders into the hands of banks. Papers filed in a case, now before the California Supreme Court,³² which is challenging the practice state that \$284 million in overdraft-related

fees were collected by the defendant bank, between 1994 and 2004, from 1.1 million accounts in California receiving direct deposit Social Security payments (Schultz 2007b). The bank contends that without such fees it would be unable to provide these services to its account holders. Whether or not that is the case, Congress, in establishing an automatic exemption system, should explicitly address its application to these two bank practices. Clarification would enable benefit recipients to better ensure the security of their funds and better choose financial services that suit their needs.

Conclusion

The garnishment of federal benefits, particularly Social Security, is a national problem that calls for a federal solution. Congress, which alone can consider the full scope of the issue—including the goals of federal benefits programs, the responsibilities of financial institutions, and the federalism concerns raised by conflicting state laws and garnishment procedures—is the proper institution to respond to this issue and ensure the protection of federal benefits. An automatic exemption system offers administrative simplicity and would protect benefit recipients from the hardships of existence that Social Security itself was created to avert. As the federal government encourages the use of direct deposit, saving substantial expenses in the process, it must ensure that the funds it deposits remain in the hands (and accounts) of their intended beneficiaries.

Appendix: A Comparison of Automatic Exemption Systems

| | California | Connecticut | New York |
|---|--|--|---|
| Automatic Exemption for Single Recipient of Social Security | \$2,700 (if “one depositor is the designated payee of directly deposited social security payments”) | \$1,000 (If electronic deposits are “readily identifiable” exempt benefits, made to account in prior 30 day period) | \$2,500 (If direct deposit or electronic payments “identifiable as statutorily exempt payments” were made to account in prior 45 days) |
| Financial Institution’s Duties after Applying Automatic Exemption | 1. Freeze amount in account that exceeds automatic exemption. 2. Within ten business days provide levying officer with written notice stating that account contains directly deposited benefits and noting balance of account that exceeds statutory exemption. Levying officer then promptly serves notice on creditor. | 1. Remove funds that exceed automatic exemption and hold for 15 days from date of mailing to judgment debtor. 2. If funds are removed from account, mail judgment debtor execution and exemption claim form (provided by serving officers). | 1. Within two days of service of restraining notice or execution, serve the judgment debtor with the exemption notice and two exemption claim forms (by first class mail to last known address). These forms are provided to the bank by the issuer of the restraining notice. |
| Procedure for determining whether excess money is exempt | 1. Within 5 days of notice the creditor—to claim excess amount is not exempt—must file an affidavit with court. 2. Hearing held: burden is on debtor to prove exemption. OR If creditor does not file affidavit, levying officer shall release account. | 1. Debtor must give notice of claim of exemption to financial institution—upon receiving this bank must, within 2 days, send copy to court that issued execution. 2. Hearing scheduled. Funds held for 45 days from the date exemption claim form was received by bank, or until court order is entered. Exemption claim is prima facie evidence of exemption. 3. If no exemption is claimed within 15 days of notice to debtor, bank must turn funds over to | 1. Debtor has 20 days from postmark date of forms to submit an exemption claim form. Forms are sent to bank and creditor’s attorney. (The forms also advise debtor that she may resolve claim faster by sending creditor or its attorney written proof or documents showing money is exempt.) 2. If there is no objection by creditor, bank must release all funds claimed exempt by debtor within eight days after postmark on envelope containing exemption claim form. |

| | | | |
|--|--|---|---|
| | | serving officer and judgment creditor. | <p>3. If no exemption is claimed within 25 days of notice to debtor, funds remain subject to restraint. But right to exemption is not waived.</p> <p>4. A creditor may object to claimed exemption. Objection must include affidavit demonstrating reasonable belief that account contains non-exempt funds.</p> <p>Bank must hold funds for 21 days and then release to account holder if there is no order from court.</p> <p>A hearing is held by court, exemption claim form is prima facie evidence that funds are exempt, burden of proof is on creditor.</p> |
| Accounting for commingling (account that contains both exempt and non-exempt funds). | | First-in, First-out method: “for the purposes of determining which moneys are exempt . . . [the] most recently deposited as of the time the execution is served shall be deemed to be the moneys remaining in the account.” | The creditor or support collection unit, after receiving from the debtor an exemption claim form with proof of exemption, must apply lowest intermediate balance principle of accounting. It then instructs bank to release exempt money. |
| Other Provisions | | Connecticut also provides a procedure for the judgment creditor to submit an affidavit asserting that the protected funds in the account are not in fact exempt. The judge may then order a hearing, with the burden on the creditor to establish the amount of non-exempt funds. | |

Sources: Connecticut General Statutes §52-367b; New York Bill A08527/S6203; California Code of Civil Procedure §704.080.

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Endnotes

¹ §407 applies to Supplemental Security Income benefits through an express reference in 42 U.S.C. § 1383(d)(1). Other federal benefits are protected by similar statutes. These include veterans benefits (38 U.S.C. § 5301(a)(1)), railroad retirement benefits (45 U.S.C. § 231m), and benefits provided through the federal retirement program (5 U.S.C. § 8470).

² In order to remain exempt from garnishment these benefits, when deposited in a bank account, must retain “quality of moneys” and not become a “permanent investment.” *Philpott*, 409 U.S. at 416. In other words, they must remain “readily withdrawable” and available for an individual’s daily needs. *Id.*

³ The terms attachment, garnishment, and freeze will be used throughout this paper. Their precise meanings overlap and the Social Security Act does not expressly define these terms. For the sake of clarity, these terms will be used with the following common definitions, drawn from Black’s Law Dictionary. An attachment is “the seizing of a person’s property to secure a judgment or to be sold in satisfaction of a judgment.” Attachment is often used interchangeably with the term “sequestration.” An attachment is effectuated through a freeze, the act by which a bank, acting on a court’s order, renders an account holder’s assets immobile. A garnishment is “a judicial proceeding in which a creditor (or potential creditor) asks the court to order a third party who is indebted to or is bailee for the debtor to turn over to the creditor any of the debtor’s property (such as wages or bank accounts) held by that third party” (Bryan A. Garner 2004).

⁴ The report, which relied upon data provided by the financial institutions sampled, noted that financial institutions typically incorporate the holding or freezing of funds into the garnishment process (Social Security Administration 208a).

⁵ It should be noted that, in the sample, approximately 44% of the money garnished from accounts that received only direct deposit Social Security benefits was garnished for an Internal Revenue Tax Levy, Alimony, or Child Support, all of which are valid exceptions to the exemption provisions. (Social Security Administration 208a).

⁶ New York state law is particularly friendly to creditors, requiring minimal effort to restrain an account. Article 52 of the New York Civil Practice Law and Rules governs garnishment and permits a creditor to enforce a money judgment by serving a third party, such as a bank, which controls assets of the debtor, with a restraining notice (*Mayers v. New York Community Bancorp, Inc.*, Memorandum Opinion and Order, 2005 WL 2105810 (E.D.N.Y. Aug. 31, 2005), at 3-4). The creditor’s attorney, acting as an “officer of the court,” is able to sign this restraining notice. This notice can be served by a variety of means, including e-mail, when a bank consents to such service. This allows creditors and their attorneys to quickly serve restraining notices on a range of banks, at times fishing for debtors’ accounts.

⁷ 80% of the cases reviewed in the New York City study involved default judgments (Urban Justice 2007).

⁸ In *Mayers* the plaintiffs contended that “changes in technology which have enabled the electronic transfer of funds allow banks ‘to quickly and easily determine if an account contains only exempt money prior to restraining it.’” (*Mayers* 2005). The plaintiffs argued that these technological changes called for a re-evaluation of the procedures necessary to protect a benefit recipient’s due process rights. In determining the proper procedures, a court must balance the factors articulated in the Supreme Court’s decision in *Matthews v. Eldridge*, which outlines the balancing test courts must apply when government action might result in the deprivation of an individual’s property interest: “[R]esolution of ... whether ... procedures provided ... are constitutionally sufficient requires analysis of the governmental and private interests that are affected. More precisely, our prior decisions indicate that identification of the specific dictates of due process generally requires consideration of three distinct factors: First, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government’s interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirement would entail.” *Mathews v. Eldridge*, 424 U.S. 319, 334 (1976). It should be noted that a separate decision by another judge on the Eastern District of New York rejected a claim similar to that raised in *Mayers*. In *Huggins v. Pataki* (2002 WL 1732804 (E.D.N.Y. July 11, 2002)), the court held

that its decision of whether the NY state garnishment provision, NYCPLR § 5222, violated the plaintiff's due process rights was governed by a prior Second Circuit decision in *McCahey v. L.P. Investors*, 774 F.2d 543 (2d Cir.1985). The *Huggins* court rejected the argument that technological changes in the years since *McCahey* rendered that case distinguishable and called for new analysis of the due process concerns.

⁹ Due process refers to “[t]he conduct of legal proceedings according to established rules and principles for the protection and enforcements of private rights, including notice and the right to a fair hearing before a tribunal with the power to decide the case” (Bryan A. Garner 2004).

¹⁰ An interrogatory is “[a] written question . . . submitted to an opposing party in a lawsuit as party of discovery” (Bryan A. Garner 2004).

¹¹ The new writs require the sheriff to inform the financial institution not to attach an account that contains electronically deposited exempt funds (Pennsylvania Civil Procedure Rule 3252). The Pennsylvania forms do not specify a procedure for dealing with commingled accounts, nor do they identify a particular accounting method to be applied to such accounts.

¹² Pennsylvania's provision, unlike those discussed *infra*, does not specify an accounting method to be used in distinguishing between exempt and non-exempt funds.

¹³ The Nebraska Bankers Association raised similar arguments in successfully convincing the Nebraska Supreme Court to reject proposed changes to Nebraska's uniform garnishment forms (Nebraska Bankers Association 2007).

¹⁴ However, the state Senate President and state Speaker of the House stated in a letter to the committee that they believed the issue should be decided by the legislature (Maryland Court of Appeals Standing Committee 2007). The Rules Committee's chair recommended that the committee follow the advice of the state legislators, on the grounds that the proposed rules changes were more substantive than procedural in nature, and as such represent matters traditionally within the legislature's realm (*Id.*). After brief discussion the committee voted unanimously to leave the issue for the state legislature (*Id.*).

¹⁵ The New York provision, the Exempt Income Protection Act, was signed into law by the governor on September 26, 2008 and took effect on January 1, 2009.

¹⁶ The amount of money protected is adjusted every three years by the Judicial Council based on changes in the California Consumer Price Index (California Code of Civil Procedure § 703.150).

¹⁷ United States Senate Committee on Finance, *Frozen Out: A Review of Bank Treatment of Social Security Benefits*, September 20, 2007. Witness statements and a video of the hearing can be found at: <http://www.finance.senate.gov/sitepages/hearing092007.htm> (accessed on September 13, 2008).

¹⁸ Proposed Guidance on Garnishment of Exempt Federal Benefit Funds, Federal Register / Vol. 72, No. 188 / Friday, September 28, 2007 / Notices 55273.

¹⁹ “To our knowledge, the Social Security Administration has not spoken to this point [how depository institutions should respond to court-issued garnishment orders directing them to freeze an account] and its internal Program Operations Manual System (“POMS”) provides that the ‘responsibility [of the Social Security Administration] for protecting benefits against legal process and assignment ends when the beneficiary is paid’ and ‘if a beneficiary is ordered to pay his/her benefits to someone else, or his/her benefits are taken by legal process, he/she can use [section 207] as a personal defense against such actions.’ Our informal consultations with legal staff of the Social Security Administration have been consistent with the view that section 207 is a defense available to be asserted by the customer defense [sic] against garnishment” (Comptroller of the Currency 2007). The references to “Section 207” in this testimony refers to 42 U.S.C. § 407's location in the Social Security Act, at § 207.

²⁰ It must be acknowledged that in its comments JP Morgan Chase also noted “that many banks may not even have the systems capability to readily identify direct deposits of exempt federal benefits” (JP Morgan Chase 2007). In a

separate letter from JPMorgan Chase to South Brooklyn Legal Services (SBLs), which was submitted with SBLs' Comments on the Proposed Guidance, the bank similarly described its practices, declaring "It is standard procedure to review funds in an account prior to placing a restraint." Letter from M. Tracy Lewis to Johnson Tyler, March 14, 2007, attached to Comments of South Brooklyn Legal Services, November 26, 2007. In its Comments, JP Morgan Chase described its process upon receiving a garnishment order:

When Chase receives a garnishment order, a Chase employee identifies all accounts of the judgment debtor and reviews the account history for the previous 90-day period. We attempt to identify direct deposits of Social Security benefits and veterans' benefits by reference to the ACH code number and description, if any, accompanying the direct deposit.

We associate ACH code numbers 303, 310 and 312 with payments issued by the Social Security Administration and ACH code number 220 with payments issued by the Department of Veterans Affairs, but we understand that these numbers refer to the Regional Center issuing the payments, and do not necessarily indicate that the payments are exempt Social Security or veterans' benefits. Therefore, we have no reliable method of identifying direct deposits of exempt federal benefit payments. We have informed the Social Security Administration of our concern, and have requested that they give us guidance on how to identify these exempt direct deposit payments (JP Morgan Chase 2007).

²¹ Bank of America 2007; JPMorgan Chase 2007; Independent Community Bankers of America 2007; Huntington Bank 2007; PNC Financial Services 2007.

²² It is worth noting that the Virginia Bankers Association, in its successful campaign reversing a protection for exempt benefits instituted by the state judiciary, contended in part that the change was not authorized by the relevant statute (Kuehner-Hebert 2006).

²³ Justice Steven's dissent in *Watters* resonates with prior decisions by the Court: "With *Watters* added to this mix, a majority of justices on the Court have rejected the applicability of *Chevron* deference to preemption determinations [made by agencies] (Chief Justice Roberts and Justices Stevens and Scalia in *Watters*) or at least expressed skepticism or concerns about deferring in such circumstances" (Quester and Keest 2008).

²⁴ "j. *Effect of withdrawals and subsequent additions.* Where the trustee deposits in a single account in a bank trust funds and his individual funds, and makes withdrawals from the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, the beneficiary cannot ordinarily enforce an equitable lien upon the deposit for a sum greater than the lowest intermediate balance of the deposit. If the amount on deposit at all times after the deposit of the trust funds equalled or exceeded the amount of trust funds deposited, the beneficiary is entitled to a lien upon the deposit for the full amount of the trust funds deposited in the account. If after the deposit of trust funds in the account the deposit was wholly exhausted by withdrawals before subsequent deposits of the trustee's individual funds were made, the beneficiary's lien upon the deposit is extinguished, and if he is unable to trace the money withdrawn, he is relegated to a mere personal claim against the trustee, and is entitled to no priority over other creditors of the trustee." (Restatement (Second) of Trusts §202).

²⁵ Furst, Randy and Kara McGuire. 2008. "State laws give edge to debt collectors." Star Tribune (Minneapolis-St. Paul, Minnesota). <http://www.startribune.com/business/27314379.html?page=1&c=y> (accessed September 18, 2009) (describing Minnesota as "one of few states where a bill collector can both file a lawsuit and garnish a debtor's bank account without appearing in court").

²⁶ This provision, which had been in Ohio Rev. Code Ann. § 2716.11, was removed effective September 30, 2008. The change may have been motivated by the Sixth Circuit's decision in *Todd v. Weltman, Weinberg, & Reis*, 434 F.3d 432 (6th Cir. 2006), which upheld a District Court decision denying absolute immunity to the defendant, a creditor's law firm, in a case alleging the defendant had no factual basis for the affidavit stating its belief that Plaintiff's bank account contained non-exempt assets.

²⁷ For example, ALA. CODE §6-6-457 (1975) states: "If the garnishee fails to appear and answer, a conditional judgment must be entered against him for the amount of the plaintiff's claim." However, the state's garnishment form, State of Alabama, Unified Judicial System, Form C-21 (Front) Rev. 11/06 ("Process of Garnishment"), in its "Notice to Garnishee" states that "Social Security, SSI, VA and federal retirement moneys are all exempt under

federal law and remain so even when deposited in a bank or other financial institution. If the only money in your possession or control belonging to the defendant is Social Security, SSI, VA or federal retirement moneys, you should indicate in your answer ‘all such money is exempt from execution.’ It also explains that the command to hold a defendant’s property or money applies only to non-exempt funds.

²⁸ There are questions regarding whether banks that refuse to honor an attachment or garnishment order for an account containing only exempt funds would actually suffer any legal liability. The National Consumer Law Center, in Congressional testimony, has shared its detailed review of state exemption laws. It concluded that in all states except three, in which the issue is somewhat ambiguous, a bank is required to attach only non-exempt funds. The Center also reported that it had never heard of a case in which banks suffered even just a legal inquiry for refusing to honor an order. The banks and banking associations that have voiced this concern have also not offered a specific case in which a bank has faced such liability (National Consumer Law Center 2007).

²⁹ For an analysis of bank setoffs in relation to §407, see Prizant 2003 (arguing that setoffs do not represent “other legal process,” but that allowing bank setoffs “seems contrary to Congress’ intent in creating § 407”).

³⁰ Although it has not spoken directly to this issue, the Supreme Court has attempted to clarify the meaning of “other legal process,” stating that this “should be understood to be process much like the processes of execution, levy, attachment, and garnishment, and at a minimum, would seem to require utilization of some judicial or quasi-judicial mechanism, though not necessarily an elaborate one, by which control over property passes from one person to another in order to discharge or secure discharge of an allegedly existing or anticipated liability” (*Wash. State Dep’t of Soc. & Health Servs. v. Keffeler*, 537 U.S. 371, 385 (2003)).

³¹ The Tenth Circuit asserted that its decision in *Toms* was governed by the Supreme Court’s decision in *Philpott v. Essex County Welfare Bd.*, 409 U.S. 413, 417 (1973) (rejecting, as in violation of § 407, New Jersey’s attempt to seize retroactive Social Security benefits under a law that required all welfare recipients to sign an agreement promising, if they were ever fiscally able to do so, that they would repay the county welfare board for any welfare payments they had received).

³¹ The Ninth Circuit distinguished the Tenth Circuit’s decision in *Tom* (which had in part relied on a prior Ninth Circuit decision, *Crawford v. Gould*, 56 F.3d 1162 (9th Cir.1995)) on the grounds that the defendant-bank in *Tom* “used the Social Security deposits to satisfy a separate, pre-existing debt unrelated to the operation of the depositor’s checking account. The act of depositing the funds into the checking account was thus not an indication of an intention to pay the separate debt. Had the depositor consensually arranged an automatic payment of the loan from the account containing the Social Security funds, we suspect the result would have been different” (*Lopez v. Washington Mutual*, 302 F.3d at 906).

³² The petition for review in the case, *Miller v. Bank of America*, was granted on March 21, 2007, 56 Cal.Rptr.3d 471, (Cal. 2007).