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Protecting Disability Benefits from Creditors

By James W. Speer

James W. Speer
Executive Director

Virginia Poverty Law Center
700 E. Franklin St. Suite 14T1
Richmond, VA 23219
804.782.9430
jay@vplc.org

Lori Burt, the widow of a disabled Vietnam veteran, lives in Roanoke, Virginia, on a widow's pension of \$1,137 per month. At 56 she finds her mothering role extended as the full-time caretaker of an adult daughter who is severely disabled. Under the intense pressure of tight finances a couple of years ago, Burt used a credit card obtained through one of those unsolicited credit card offers that fill all of our mailboxes to pay medical expenses. Her efforts to make monthly payments were soon overcome by late charges and interest. She fell so far behind in her payments that she was sued in Richmond (188 miles away).

Burt had her federal veterans' benefits directly deposited into her bank account because it was safe and convenient. After the credit card company obtained a judgment against her, the company garnished her bank account. The first time she heard about it, the bank had frozen her account and bounced two grocery store checks, charging her every time a check was dishonored. All her monthly utility checks remained unpaid and could bounce twice before those services got cut off for nonpayment. Criminal charges and additional statutory fees for writing bad checks were just a certified mail letter away. Her bank was charging her \$75 for the "service" of giving away her exempt money. Burt tried to get the bank and the credit card company to release her funds, but they would not do so. She had to ask for a court hearing in Richmond. A few weeks after the account was frozen, the court dismissed the garnishment, and a week later the funds were released. Burt learned that her money was not safe in the bank, and she would now get her check sent directly to her.¹

Having worked in legal services for almost twenty years, I cannot tell you how many times I have heard this or a similar story. But wasn't Burt right? Isn't her veterans' benefit safe from her creditors? Why then did she find herself in court fighting to get her funds unfrozen? To answer these questions about Burt's situation or that of any beneficiary of disability benefits, you need to know the source of the benefits, where the benefits are currently held, and which creditor is trying to get the benefits. Further, to understand why Burt ended up in this situation one has to understand how the modern banking system is failing to protect these benefits. Relying heavily on

¹Lori Burt (the client's name has been changed to protect her privacy) was a client of Henry Woodward, an attorney with the Legal Aid Society of Roanoke Valley, in Roanoke, Virginia.

the National Consumer Law Center legal practice manuals, I explore the law governing these questions and suggest some ways we can help our clients protect their disability benefits.²

What Is the Source of the Disability Benefit?

Most government benefit payments are exempt from creditor process under the laws governing the assistance program. The Social Security Act provides that social security and Supplemental Security Income (SSI) benefits are not transferable or assignable and forbids “execution, levy, attachment, garnishment or other legal process.”³ All federal veterans’ benefits are protected under 38 U.S.C. § 5301 and black lung benefits under 33 U.S.C. § 916. Many state exemption laws also protect workers’ compensation and other benefits.⁴

What about benefits from nongovernment disability insurance policies? Almost every state exempts a certain amount of insurance benefits from creditors. However, state statutes vary as to the amount and scope of their insurance exemptions as well as to their location.⁵ In Virginia applicable exemption statutes are spread throughout the Virginia Code. Court forms that are sent to a debtor whose wages or bank account has been garnished may offer some information. In Virginia, if your creditor attempts to garnish your property, the creditor must send you a form entitled “How to Claim

Exemptions from Garnishment.”⁶ However, I do not suggest relying on such lists as being comprehensive. Recently I learned that the form used in Virginia courts does not include an exemption for “installment payments” from an “accident and sickness” insurance policy (also known as disability benefits).⁷

What Happens When the Beneficiary Deposits the Funds in Her Bank Account?

Most recipients of government disability benefits now get their funds electronically deposited.⁸ Burt set up direct deposit of her U.S. Department of Veterans Affairs check because it was less expensive, more secure, and faster than depositing the money in person. She also saved the federal government money by having her checks directly deposited. According to the U.S. Department of the Treasury, the government has saved \$6 billion since 1986 due to direct deposit.⁹ This cost savings is one of the reasons why a federal statute, the Debt Collection Improvement Act of 1996, commonly called EFT 99, requires that federal government agency payments to consumers be transmitted electronically unless the consumer seeks a waiver.¹⁰

Congress was concerned about the effect of mandating electronic payment to millions of federal recipients who do not have a bank account. In response, EFT 99 requires the U.S. Department of the Treasury to protect these recipients.¹¹

²As most legal aid consumer attorneys know, handling a consumer case without using the National Consumer Law Center practice manuals is risking malpractice. These manuals include a much more detailed discussion of the issues raised here.

³42 U.S.C. §§ 407(a), 1383(d)(1).

⁴NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.5.5.1 (5th ed. 2004 & 2006 Supp.). For summaries of all state exemption laws, see Appendix F of the 2006 Supplement.

⁵NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION, § 12.5.8.

⁶This notice is sent because of due process concerns. See *id.* § 12.3. This is the form that Burt filled out and sent to the court.

⁷VA. CODE ANN. § 38.2-3406 (1950 as amended).

⁸More than 80 percent of all social security recipients get their benefits by direct deposit in 2007, according to the Social Security Administration website, www.ssa.gov/deposit/trendenv.shtml.

⁹See www.godirect.org/about_didYouKnow.cfm.

¹⁰Debt Collection Improvement Act of 1996, 31 U.S.C. § 3332.

¹¹Apparently that concern was well founded because less than 58 percent of Supplemental Security Income (SSI) recipients get direct deposit in 2007 according to the Social Security Administration website, www.ssa.gov/deposit/trendenv.shtml.

The Treasury created a special Electronic Transfer Account (ETA). Exempt funds in an ETA may not be garnished, and fees are sharply limited. However, very few banks offer ETA accounts, and those that do offer them do not market them.¹² Apparently none of the biggest national banks offers ETAs. Some argue that the reason for this is that big banks can make more money fronting for check cashers and other noneligible entities than they can from maintaining ETA accounts.¹³

Even if exempt funds are deposited into an account that is not an ETA, the benefits usually remain exempt. In *Porter v. Aetna Casualty and Surety Company* the U.S. Supreme Court held that veterans' disability benefits deposited in a bank account remained exempt so long as they were readily traceable and "retain the quality as moneys"; that is, they are readily available for the day-to-day needs of the recipient and have not been converted into a "permanent investment."¹⁴ The statutes creating federal and state benefit programs, such as veterans' benefits, social security benefits, and workers' compensation benefits generally exempt those benefits from attachment by creditors when those benefits are deposited into a bank account as long as the funds are available on demand or for the support of the beneficiary and are not converted into a permanent investment. The same reasoning holds that state-law

exemptions for payments from private disability insurance policies or annuities continue after payment or deposit.¹⁵

What if the exempt benefits are deposited into an account with funds that are not exempt? "Commingling" of exempt with nonexempt funds in the bank account may make it difficult to determine whether the funds are exempt at the time the account is garnished. Most courts will continue to protect such funds, generally applying a first-in first-out accounting method.¹⁶ Some courts, finding that the exemption was lost when the funds were commingled, refused to trace.¹⁷ For an individual to list another person, perhaps a relative or friend, jointly on a bank account even though only one of them deposits funds into the account, is not uncommon. However, the arrangement can create problems when the non-contributor is a judgment debtor. Most jurisdictions are in agreement that joint accounts are subject to legal process by the creditor of a single codepositor, but only to the extent of the debtor-depositor's equitable interest in the funds.¹⁸

Who Is the Creditor and What Is the Nature of the Debt?

Many exempt funds may be reached for a child support or alimony debt. Child support and alimony may be collected from social security benefits, but not SSI

¹²See NATIONAL CONSUMER LAW CENTER, CONSUMER BANKING AND PAYMENTS LAW § 10.8.1. A quick search at www.eta-find.gov found only twenty-one bank branches offering Electronic Transfer Accounts (ETAs) in Virginia. Other states have far more branches. E.g., New York has 524 locations, and Ohio has 1,114.

¹³The U.S. Department of the Treasury requires electronic payments be made only to federally insured financial institutions. 31 C.F.R. § 208.6(a). Some banks work with check cashers, convenience stores, and other businesses to set up accounts that are only a conduit to receive the funds and pass them along. This is called "fronting." For further information about how the availability of alternative financial service providers has undermined the popularity and use of the ETAs, see NATIONAL CONSUMER LAW CENTER, CONSUMER BANKING AND PAYMENTS LAW § 10.7, *supra* note 12.

¹⁴*Porter v. Aetna Casualty and Surety Company*, 370 U.S. 159 (1962).

¹⁵*Parl v. Parl*, 699 So. 2d 765 (Fla. Dist. Ct. App. 1997); *In re Hunt*, 250 B.R. 482 (Bankr. E.D.N.Y. 2000). See NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION, § 12.6.2.

¹⁶*Tom v. First American Credit Union*, 151 F.3d 1289 (10th Cir. 1998); *NCNB Financial Services v. Shumate*, 829 F. Supp. 178 (W.D. Va. 1993), affirmed without op., 45 F.3d 427 (4th Cir. 1994). See more cases cited in NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.6.4.

¹⁷The National Consumer Law Center manual cites only one case, *Bernardini v. Central Bank*, 290 S.E. 2d 863 (Va. 1982), involving a depository bank collecting its own debt by setoff. Many Virginia courts do not follow this ruling when a creditor, other than the depository bank, is garnishing the account.

¹⁸See *Sears Roebuck and Company v. Cosey*, 44 P.3d 582 (Okla. Civ. App. 2002); *Pinkstaff v. Hill*, 827 S.W.2d 747 (Mo. Ct. App. 1992), and other cases cited in NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.7.1.

benefits.¹⁹ Veterans' benefits and workers' compensation benefits may also be reached for child support or alimony owed.²⁰ However, veterans' disability benefits and workers' compensation provided to pay medical expenses may remain exempt.²¹

If the creditor is also the bank that holds the deposit account, the funds may be subject to the banker's right of setoff. The banker's right of setoff is based on common law or state statute. A bank may be permitted to deduct money from a depositor's account if that depositor owes money to the bank. Rather than having to sue to collect, the bank is permitted to take the money in the account. Arguments that the common-law right of setoff violates due process because it is a type of pre-judgment seizure have not been successful. Where the right of setoff derives from common law, or contract, courts hold that there is no state action and therefore no federal constitutional implications.²² The majority rule is that otherwise exempt income is also exempt from setoff.²³ However, a significant minority of courts, through a variety of rationales, allows a setoff against these same types of funds.²⁴ Many credit cards are issued by banks that may also have a deposit account relationship with the cardholder. The Truth

in Lending Act now provides that a credit card issuer may not take funds out of a deposit account to satisfy a credit card debt except under an automatic payment plan previously authorized by the cardholder in writing.²⁵

What if a debt is owed to the federal government? The Debt Collection Improvement Act of 1996 permits administrative offset against exempt social security, black lung, and railroad retirement benefits.²⁶ Offset is limited to 15 percent of the benefits, and, in addition, \$9,000 per year (\$750 per month) is exempt. In computing whether any portion of benefits is available for offset, amounts already being deducted to repay overpayments and to pay Medicare insurance premiums are not counted as received by the debtor.²⁷ For example, if a debtor's \$850 monthly social security benefit amount is reduced by a \$45 monthly Medicare premium and a \$50 monthly deduction to repay an overpayment, leaving the debtor with a \$755 monthly check, only the amount in excess of \$750—in this example \$5—is available for offset.²⁸

What Might Debtor Have Done to Protect Her Benefits?

If Burt had come asking for advice at a legal aid office when the credit card com-

¹⁹"[M]oneys the entitlement to which is based upon remuneration for employment due from, or payable by, the United States ... shall be subject, in like manner and to the same extent.... enforce the legal obligation of the individual to provide child support or alimony" (emphasis added). 42 U.S.C. § 659(a). This does not include SSI since it is a needs-based program and is not based upon what a person pays into the system. NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.5.10.3 (2006 Supp.).

²⁰For veterans' benefits, see *Loving v. Sterling*, 680 A.2d 1030 (D.C. 1996). For workers' compensation benefits, see *Moyle v. Director, Office of Workers' Compensation Programs*, 147 F.3d 1116 (9th Cir. 1998); more cases are cited in NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION 532 n.485.

²¹For veterans' disability benefits, see *Ex parte Billeck*, 777 So. 2d 105 (Ala. 2000); *Scheidel v. Scheidel*, 4 P.3d 670 (2000); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.5.3. For workers' compensation benefits, see *Lisby v. Lisby*, 890 P.2d 727 (Idaho 1995); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.5.10.3.

²²*Kruger v. Wells Fargo Bank*, 521 P.2d 441 (Cal. 1974); *Meyer v. Idaho First National Bank*, 525 P.2d 990 (Idaho 1974); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.6.7.2.

²³*Tom v. First American Credit Union*, 151 F.3d 1289 (10th Cir. 1998); *Marengo v. First Massachusetts Bank*, 152 F. Supp. 2d 92 (D. Mass. 2001); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.6.7.1.

²⁴*Lopez v. Washington Mutual Bank*, 302 F.3d 900 (9th Cir. 2002); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.6.7.3.

²⁵15 U.S.C. § 1666h.

²⁶Debt Collection Improvement Act of 1996, 31 U.S.C. § 3332.

²⁷NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 13.2.8.2.

²⁸Overpayment of benefits due to errors by the beneficiary or the government (much more likely) may be collected by withholding all or part of future checks. For more information about how to appeal or ask for a waiver of overpayment, see www.ssa.gov/online/ssa-632.html.

pany sued her, she probably would have been told that she was judgment-proof because her veterans' benefits may not be garnished and she had no other assets that a creditor could attach. Many, if not most, legal aid offices would not file a bankruptcy for her if she is judgment-proof. What other advice could we give her?

I always advise a client who might be facing a lawsuit for a debt to avoid commingling exempt and nonexempt funds in her bank account in case the creditor tries to garnish the bank account. Although the majority of courts still protect the exempt funds if they are commingled, it is best to avoid that problem. Commingling might also necessitate a court appearance after a garnishment in order to prove which funds are exempt.

Burt might have considered sending to her bank a letter advising the bank that the account contained exempt funds.²⁹ This would put the bank on notice, and some banks might actually make a note on the account and not freeze it if a garnishment is received. As most clients do not call back after we give them this advice, it is hard to tell if this strategy works.

Another strategy would be to keep her funds in an account such as an ETA that may not be garnished. However, since not many banks offer such an account, there may not be any available in the client's area.³⁰

How can you help the client who comes to see you after the bank has already frozen her bank account? Most legal aid programs will treat these situations as emergencies and seek to release the garnishment quickly so that the client will not be forced to survive with no money.

Many clients are able to get the creditor to release the garnishment when the attorney sends the creditor information demonstrating that the funds in the account are exempt. In my experience, most creditors release the garnishment if they receive copies of a few months' bank statements showing direct deposit of exempt funds. This is more difficult if the funds are not direct-deposited or are commingled. In those cases a court appearance might be necessary.

What Can We Do About Banks Freezing Accounts with Exempt Funds?

May the bank take a garnishment fee out of the exempt funds? Burt's bank charged her \$75 as a garnishment fee. This can be particularly galling after the bank freezes an account and forces the depositor to go to great lengths to get her exempt funds returned. The source of the consumer's liability for bank fees is the agreement between the consumer and the bank. Often this is the "signature card" an individual signs when she opens the account. Banks periodically raise fees and impose fees on services formerly offered without charge, and that is permitted as long as it is authorized in the original agreement.³¹ But even if the agreement allows the bank to assess the fee, may the bank take exempt funds from the account as a setoff? The majority rule is that, if the funds are exempt from garnishment, they are also exempt from setoff.³² A significant minority of courts, through a variety of rationales, allow setoff against these same types of funds.³³

A few banks have announced that they will not freeze accounts with exempt funds or have initiated internal policies against

²⁹The Legal Services of Northern Virginia website suggests the following language: "I am writing to advise you that the above bank account is exempt from garnishment because the only source of money in the account has been and will continue to be exempt income. The only deposits are automatic electronic deposits of...."

³⁰For a list of area bank branches that offer the ETA, go to www.eta-find.gov.

³¹See NATIONAL CONSUMER LAW CENTER, CONSUMER BANKING AND PAYMENTS LAW § 4.5.

³²*Tom*, 151 F.3d at 1289; *Kruger*, 521 P.2d at 441; NATIONAL CONSUMER LAW CENTER, CONSUMER BANKING AND PAYMENTS LAW § 4.3.8.

³³*Lopez v. Washington Mutual Bank*, 302 F.3d 900 (9th Cir. 2002); NATIONAL CONSUMER LAW CENTER, CONSUMER BANKING AND PAYMENTS LAW § 4.3.8.

freezing accounts with exempt funds.³⁴ Advocates might seek meetings with other banks and credit unions and ask them to adopt such policies. Although most banks and credit unions belong to trade associations claiming that to do anything but freeze every account that is garnished is too burdensome, some might ignore the trade association's stance if it were in that particular bank or credit union's best interests.

Court forms used for garnishments in many states may offer an avenue for advocates to stop automatic freezing of accounts with exempt funds. A few years ago, in an attempt to stop banks from freezing bank accounts containing only direct-deposited exempt funds, several Virginia legal aid lawyers asked the Virginia Supreme Court to change the garnishment forms.³⁵ The Virginia Supreme Court approved the change, and some small banks stopped automatically freezing such accounts. The big banks ignored the forms and continued to freeze all accounts. After one legal aid attorney obtained an order of contempt against one of the big banks, the banks decided to flex their political muscle and put an end to the legal aid effort.³⁶ The good news is that form and court rule changes have taken place in other states, and banks have not yet beaten back all attempts to restore sanity to the garnishment process.

Congress and the states protect exempt funds from creditors for good reasons. I have seen far too many legislators and judges look upon these protections as technical obstacles to a creditor exercising his "rights." We should reexamine the reasons for exemption laws so that we can remind judges and legislators. These laws are intended to

- provide the debtor with enough money to survive;

- protect the debtor's dignity;
- afford a means of financial rehabilitation; and
- protect the family unit from impoverishment.³⁷

Of course, the real solution to the failure of banks to protect depositors' exempt funds is legislation to require banks to do what is right. This will prove difficult to accomplish because of the political power of banks. In the meantime, legal aid attorneys will continue to represent many disabled clients who come to us in a crisis because their sole source of income has been frozen by garnishment of an otherwise exempt account. By the time we obtain a release of the garnishment, much damage will have been done. The client will have typically bounced a number of checks paid to a landlord, to utility companies, to an auto loan company, or to others and incurred a number of bank charges and bad-check charges. They are unable to access the account to withdraw cash for groceries, gas, and essential medications. Some clients have been unable to pay for medication and have had to go the emergency room; many clients receive eviction notices when their rent checks bounce. Our clients' monthly budgets are a delicate balancing act even before the garnishment summons arrives. Most ominous is that this represents only the tip of the iceberg. I hope my suggestions alleviate the problems faced by our clients until Congress or state legislatures take appropriate action.

Author's Acknowledgment

I would like to thank Henry Woodward, Legal Aid Society of Roanoke Valley, for telling his client's story for the beginning of this article.

³⁴According to information obtained from listservs, JP Morgan Chase, NY Community Bank, and Banco Popular will not automatically freeze accounts with exempt funds.

³⁵The Virginia Supreme Court creates the court forms used in state courts.

³⁶The legal aid attorney was Henry Woodward, Legal Aid Society of Roanoke Valley, who also represented Burt. For the Virginia saga, see Katie Kuehner-Hebert, *Who Determines Whether a Deposit Can Be Garnished?* AMERICAN BANKER, Dec. 14, 2006). For a more unbiased account, see Rob Johnson and Ray Reed, *Observers Debate Banks Obligations in Garnishments*, ROANOKE TIMES, Nov. 6, 2006, at 1.

³⁷For a more thorough discussion of this topic and case cites, see NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 12.2.1.

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