

# Exempt Income Protection Act Better Protects Strapped Debtors

Johnson M. Tyler, *NYLJ*, January 27, 2009

Exemption laws protect Social Security<sup>1</sup> and other subsistence and retirement payments from creditors.<sup>2</sup> They ensure that a disabled, elderly or impoverished person can eat, buy medicine and remain housed.

But in the last six years, exemption laws have routinely been skirted by debt-collection law firms exploiting unforeseen weaknesses in electronic banking.

Nowhere is this problem bigger than in New York, which has some of the most powerful debt-collection laws in the country.<sup>3</sup> Consequently, New York's civil courts and Legal Services offices have been inundated with complaints by seniors and the disabled that a creditor has frozen Social Security or pension checks. Such freezes make it difficult for the account holder "to survive" and have reached "crisis" proportions, according to Administrative Judge Fern A. Fisher of the Civil Court of the City of New York.<sup>4</sup>

New York's Exempt Income Protection Act (EIPA)<sup>5</sup> eliminates the conflict between New York's debt-collection procedures and federal and state exemption laws. The EIPA, effective Jan. 1, 2009, automatically exempts the first \$1,716 of any bank account from debt collection. And if the account receives any statutorily exempt, electronic payment, such as Social Security, the exemption floor is set higher at \$2,500.

## Poignant Illustration

The ordeal of Waverley Taliaferro illustrates the problem the EIPA fixes.<sup>6</sup> Like 30 percent of Social Security retirees,<sup>7</sup> Mr. Taliaferro's only income is a monthly Social Security payment. Federal law unequivocally protects Social Security from "execution, levy, attachment, garnishment, or other legal process . . . ."<sup>8</sup> Nevertheless, a large debt-collection firm using a New York statute froze Mr. Taliaferro's Social Security deposits at Citibank.<sup>9</sup> Although bank statements and Citibank's computer showed the account contained only the remnants (\$47) of Mr. Taliaferro's last, electronic Social Security payment,<sup>10</sup> Citibank was compelled to honor the restraint lest it face contempt charges or liability for ignoring the order.<sup>11</sup>

A few days after the restraint, Mr. Taliaferro's next Social Security check sailed electronically into the frozen account. Because of the restraint, Citibank would not allow Mr. Taliaferro to withdraw that payment. Mr. Taliaferro now had no

money to pay rent or buy food. Although Mr. Taliaferro obtained a lawyer who proved to the debt-collection law firm that the account was exempt, the firm still refused to unfreeze the account unless Mr. Taliaferro entered into a monthly payment plan. Such a settlement was contrary to federal and state exemption laws as it required Mr. Taliaferro to surrender each month a portion of his exempt income. Only under threat of a Fair Debt Collection Practices Act<sup>12</sup> law suit did the firm relent and release the account.

By then, 23 days had passed during which Mr. Taliaferro went through his food staples and then survived on nothing but rice, three times a day, seven days a week. Six months later, Mr. Taliaferro's account was frozen again.

Mr. Taliaferro's experience is typical of tens of thousands of low-income New Yorkers. While no exact figures exist, each year about 300,000 consumer debts are reduced to judgment in New York City alone.<sup>13</sup> Ninety-three percent of these judgments are obtained by default, raising serious questions regarding whether the defendant was ever served.<sup>14</sup> And most of these judgments are enforced through bank freezes. But the large number of judgments and bank freezes alone does not explain the passage of the EIPA. To understand further why the New York Legislature enacted the EIPA, one needs to look back one decade.

### **Rise in Credit Card Debt**

The original business model for credit card companies was to issue cards to consumers who posed little risk of not paying their bills.<sup>15</sup> A 1996 U.S. Supreme Court decision, *Smiley v. Citibank*, flipped this model on its head.<sup>16</sup>

By defining credit card penalty fees as interest, *Smiley* allowed a credit card company to export weak usury laws from the state of incorporation (usually South Dakota or Delaware) to every other state, effectively gutting local anti-gouging laws. Thereafter, credit cards companies started issuing cards to low-income people who would have difficulty making timely payments and thus would generate hefty penalty fees.<sup>17</sup> This new business model generated staggering profits.<sup>18</sup> At the same time, it fostered substantial credit-card debt among low-income persons on fixed incomes that are exempt from debt collection, such as welfare, Supplemental Security Income (SSI), and Social Security.<sup>19</sup>

Some of this debt is the product of living beyond one's means. However, the vast majority involves use of the credit card as a "plastic safety net" when confronted with loss of income (job loss, illness, or divorce) or emergency expenses (medical bills and car repairs.)<sup>20</sup> And a significant portion of the credit card debt is related to the "tricks and traps" loaded into credit cards that evolved after the *Smiley* decision, e.g., 29 percent interest rates, \$39 late fees, \$49 over-limit fees, \$15 phone payment charges, and universal default.<sup>21</sup>

### **• *Electronic Banking Enables Debt Collectors to Squeeze Blood From***

## **Stones**

Coupled with the expansion of credit card debt was the electronic banking revolution. In 1998, regulations went into effect requiring electronic payment of Social Security, Veterans and other federal benefits.<sup>22</sup> Although the regulations contain an opt-out provision, today more than 86 percent of Social Security and Veterans beneficiaries receive payments electronically.<sup>23</sup> And for most people, electronic banking is terrific. It ensures receipt of crucial benefits, decreases crime, and saves taxpayers and consumers money.<sup>24</sup>

But for low-income persons with debts, electronic banking is a nightmare.<sup>25</sup> Direct deposit bank accounts are plump targets for debt collectors, even when they have only a few dollars in them. This is because, as seen in Mr. Taliaferro's case, the next Social Security check invariably sails electronically into the frozen account, becoming unavailable to the account holder. This loss of an entire month's income gives a debt collector unprecedented leverage to "negotiate" a settlement or monthly payment plan.

As one unlucky retiree who surrendered her exempt payments to a creditor during a bank freeze explained, "I was on my knees. It was like our last dollar. I didn't even have money to buy gas to get home."<sup>26</sup> Those who refuse a payment plan pay dearly as the debt collector can simply order the sheriff to take all the frozen money.<sup>27</sup> Such was the case of Diane Miceli, a disabled legal secretary and single mother who watched helplessly as her frozen account swelled from \$174 to over \$1,600 in unreachable, electronic Social Security and Child Support payments. The creditor took those moneys after she refused to enter into a payment plan.<sup>28</sup>

### **'Blitzing the Banks'**

The final development contributing to the tremendous number of New York bank restraints is a little known amendment to the CPLR in 2000.<sup>29</sup> It allows debt collectors to computer match the names and Social Security numbers of judgment debtors against bank records. A large debt-collection firm describes this process as "blitzing the banks" whereby the firm runs tens of thousands of judgment debtor names through bank data bases looking for matches.<sup>30</sup> When an account is matched, the debt-collection firm freezes it.

No state other than New York entrusts debt collectors with such a potent discovery tool.<sup>31</sup> Consequently, locating and freezing the bank account of a New York debtor is now as simple (and cheap) as clicking a mouse. Small debts normally overlooked as too costly to collect in other states are highly profitable in New York, making debt collection big business in New York. Indeed, the number of debt-collection firms in New York City has doubled in the last two years.<sup>32</sup>

And because electronic bank matching is automated, repeated freezing of a bank

account containing only exempt moneys is the norm rather than the exception. Such was the experience of Doreen Washington, a homeless and disabled mother who had her SSI payments frozen three times over a 22-month period for the same debt.<sup>33</sup> Similarly, the three debtors in a constitutional challenge to New York's restraining notice provision each had their bank accounts restrained multiple times by creditors.<sup>34</sup>

## **EIPA Ends Bank Freeze**

While electronic banking contributes significantly to the bank freeze epidemic, it also provides a solution. Each direct deposit statement includes information alerting the bank that the deposit is exempt.<sup>35</sup> And the exempt character of Social Security payments is not lost when the money is deposited into an account, moved from one account to another, or commingled with nonexempt money.<sup>36</sup>

The EIPA compels a bank to inquire, upon receipt of a restraining notice, whether a bank account receives any electronically deposited, exempt payment.<sup>37</sup> If the account does receive such deposits, only the balance exceeding \$2,500 may be frozen.<sup>38</sup> This is true even if the account contains nonexempt deposits. If the account does not receive any direct deposit, only the balance exceeding \$1,716 may be restrained, regardless of the source of the deposit.<sup>39</sup> The \$1,716 floor is the equivalent of two month's minimum wage, and reflects New York's long-standing wage exemption laws.<sup>40</sup> If the balance is less than \$1,716 (or \$2,500 for electronic deposit of exempt funds) the restraint is void.<sup>41</sup>

## **Exemption Claims Procedure**

The EIPA includes a new claims procedure that the debtor can use when his account contains more than the automatic exemption and thus some money is frozen.<sup>42</sup>

Under EIPA, the judgment creditor's attorney must serve the bank with an "Exemption Claim Form" along with his or her restraining notice. If any funds are actually restrained, the bank, in turn must send the "Exemption Claim Form" to the debtor. If the frozen moneys are exempt, the debtor can complete and return this form to the bank and creditor's within 20 days. When filing the Exemption Claim Form, a debtor is encouraged to attach bank statements and other proof that his or her account is exempt. Unless the creditor's attorney objects to the claim, the bank will automatically release the account without a court order within eight days of receipt of the claims form.

If the creditor objects (via a motion),<sup>43</sup> the restraint stays in effect until a judge issues an order following a hearing. And the judge must act quickly. Under the EIPA, the bank must release the account within 21 days of the debtor's filing of the exemption claim even when the creditor files an objection.<sup>44</sup>

To deter meritless objections by creditors, a debtor may seek attorney's fees, actual damages, and statutory damages (up to \$1,000) when a creditor objects in bad faith to an exemption claim.<sup>45</sup>

In the event that the debtor fails to assert an exemption, the restraint stays in effect for a year, as has always been the case.<sup>46</sup> The creditor can take this frozen money at anytime by issuing an execution notice with the sheriff (or marshal in New York City.)<sup>47</sup> The sheriff too must give the debtor an opportunity to raise his or her exemption.<sup>48</sup> Barring the filing of an exemption claim by the debtor, the bank will send the restrained money to the marshal no sooner than 25 days after the debtor has been mailed the Exemption Claim Form.<sup>49</sup>

### **Other Features of the EIPA**

The EIPA also limits the number of restraining notices a judgment creditor can impose on an account to two per year.<sup>50</sup> This will stop creditors from repeatedly restraining accounts that are exempt, as happens now.<sup>51</sup>

The EIPA prohibits a bank from charging any fee when the account balance is below the automatic exemption floor (\$2,500 or \$1,716), thereby voiding the restraint.<sup>52</sup> Prior to the EIPA, low-income debtors such as Michelle Severin lost hundreds of dollars in bank fees when their direct deposit account containing only Social Security was frozen.<sup>53</sup>

The EIPA also has a built in cost-of-living adjustment (COLA).<sup>54</sup> The EIPA is partially modeled after Connecticut's debt-collection procedures.<sup>55</sup> Connecticut's laws have been weakened considerably the absence of a COLA provision, as well as bad-faith penalties when a creditor objects without merit to a debtor's exemption claim.<sup>56</sup>

### **The Bank Freeze Epidemic**

Experts estimate that well over 1 million Social Security recipients each year have their bank accounts frozen.<sup>57</sup> A state-by-state solution, while a start, is time-consuming and uncertain. Indeed, in the last eight years, six states in addition to New York have sought to amend their laws to protect Social Security and other exempt payments from creditors. Yet only three have succeeded.<sup>58</sup>

Congress is well-aware of the bank freeze problem, having held two hearings on the issue.<sup>59</sup> Bank regulators too have requested comments regarding how banks can better protect Social Security payments from debt collectors.<sup>60</sup>

And while most banks wish to avoid further regulation, the nation's largest banks recognize the need for a federal, not state-by-state, solution. Chase, Bank of America and the American Bankers Association favor a federal rule that sets a bright-line dollar amount that cannot be frozen when an account contains any

electronically deposited exempt funds.<sup>61</sup> With the passage of the EIPA, Washington needs to look no further than New York for such a model.

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### Endnotes:

1. 42 U.S.C. 407(a).
2. For a general, yet nonexhaustive list of additional sources of income exempt from debt-collection (including Supplemental Security Income, public and private pensions, unemployment benefits, public assistance, and child support) see N. Y. C.P.L.R. 5222(e).
3. See *infra* note 28 and accompanying text.
4. The Urban Justice Center, "Debt Weight: The Consumer Credit Crisis in New York City and Its Impact on the Working Poor" (October 2007); MFY Legal Services, "Justice Disserved: A Preliminary Analysis of the Exceptionally Low Appearance Rate by Defendants in Lawsuits Filed in the Civil Court of the City of New York" (June 2008); Schultz, Ellen, "The Debt Collector vs. the Widow, Viola Sue Kell Thought Her Social Security Benefits Were Safe in the Bank. She Was Wrong," *Wall St.J.*, April 28, 2007); Baribeau, Simone "Direct Deposit of Social Security Checks: Safe, Fast and Disastrous. As Federal Agencies Push for Recipients to Use Direct Deposit, Consumer Advocates Warn of Risks," *The Christian Science Monitor* (March 14, 2007.)
5. 2008 Sess. Law News of N.Y. Ch. 575 (A. 8527-A) (effective Jan. 1, 2009.)
6. "Frozen Out: A Review of Bank Treatment of Social Security Benefits," Hearing before the Committee on Finance, U.S. Senate, (Sept. 20, 2007) (prepared statement of Waverly Taliaferro, Social Security recipient from New York), <http://finance.senate.gov/hearings/testimony/2007test/092007testwt.pdf>.
7. Social Security Administration, *Fast Facts & Figures About Social Security*, 2007, p. 7 (September 2007) (34 percent of Social Security recipients rely on Social Security for 90 percent or more of their monthly income.) And 17 percent live at or below the poverty line. *Id.* at p.8.

8. 42 U.S.C. 407(a).
9. The restraining notice was issued pursuant to N.Y. CPLR 5222.
10. Every bank must list the source of any electronic deposit on a customer's bank statement. 12 CFR 205.9(b)(1)(v). Social Security deposits are universally denoted on bank statements as "US Treasury, Soc Sec."
11. N.Y. CPLR 5222(a) and 5251.
12. 15 U.S.C. 1692 et seq.
13. The Urban Justice Center, "Debt Weight: The Consumer Credit Crisis in New York City and Its Impact on the Working Poor" (2007).
14. Id.
15. Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers, Hearing before the Committee on Banking, Housing and Urban Affairs of the United States Senate, (Jan. 25, 2007) (prepared statement of Elizabeth Warren, Harvard Law School Professor.)
16. 517 U.S. 735 (1996).
17. U.S. General Accounting Office "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosure to Consumers" (GAO 06-929) (October 2006).
18. Credit-card penalty and cash-advance fees climbed from \$1.7 billion in 1996 when *Smiley* was decided to \$16.4 billion in 2005. And the average late fee has jumped from \$13 in 1996 to over \$30 in 2007. Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers, Hearing before the Committee on Banking, Housing and Urban Affairs of the United States Senate, (Jan. 25, 2007) (prepared statement of Robert D. Manning, Ph.D., Rochester Institute of Technology Professor.)
19. For example, older Americans on retirement income now carry an average of \$6,000 in credit card debt, as opposed to \$2,000 in 1992. Loonin and Renuart "The Life and Debt Cycle: the Growing Debt Burdens of Older Consumers," 44 Harv. J. on Legis. 167 (2007).
20. Draut, "The Plastic Safety Net, the Reality Behind Debt in America" (2005.)
21. Supra note 15.
22. 31 U.S.C. 3332 and 31 C.F.R. Pt. 208 (Sept. 25, 1998.)

23. Social Security Direct Deposit and Check Statistics, December 2008. Available at <http://www.ssa.gov/deposit/GIS/data/Reports/T2StateSum.htm>.
24. See [www.Godirect.org](http://www.Godirect.org). The U.S. Treasury would save an additional \$130 million annually if the remaining federal beneficiaries who received paper checks switched to electronic delivery. [www.Godirect.org/about-faq.cfm#5](http://www.Godirect.org/about-faq.cfm#5).
25. See, e.g., Baribeau, Simone "Direct Deposit of Social Security Checks: Safe, Fast B and Disastrous. As Federal Agencies Push for Recipients to Use Direct Deposit, Consumer Advocates Warn of Risks," *The Christian Science Monitor*, March 14, 2007.
26. Schultz, Ellen, "The Debt Collector vs. the Widow: Viola Sue Kell Thought Her Social Security Benefits Were Safe in the Bank. She Was Wrong." *Wall St.J.*, April 28, 2007.
27. N. Y. CPLR 5230 and 5232.
28. *Lincoln Financial Services Inc., v. Miceli*, 17 Misc.3d 1109(A) (Nassau Ct Civ. Court 2007).
29. N.Y. CPLR 5222(g); 5224(a)(4).
30. Lagnado, Lucette, "Cold-Case Files: Dunned for Old Bills, Poor Find Some Hospitals Never Forget," *Wall St.J.* June 8, 2004.
31. *Id.*
32. Fredrickson, "Thriving on Debtors' Woes, Collection Firms Expand in New York," *Crains New York Business*, Oct. 20, 2007.
33. *Washington v. Gutman, Mintz*, 07 CIV. 4096 (EDNY 2008) (FDCPA claim against creditor for repeated restraints.)
34. *Mayers v. N.Y. Cmty. Bancorp Inc.*, No. CV-03-5837, 2005 WL 2105810 (E.D.N.Y. Aug. 31, 2005) action voluntarily dismissed following passage of the EIPA (Dec. 3, 2008.)
35. See *supra* note 12.
36. *Philpott v. Essex County Welfare Board*, 409 U.S. 413, 415 (1973); *Heymann v. Brechner*, No. 95 Civ. 1329, 1996 WL 580915, at \* 7 (S.D.N.Y. Oct. 9, 1996) (When exempt Social Security payments are commingled with nonexempt money, the funds remain exempt to the extent that they can be "reasonably traceable" to Social Security deposits.) Consequently, Social Security recipients

have sought to require a bank, under the Due Process Clause, to determine if an account contains only exempt, direct deposit payments before honoring a restraining notice. *Mayers v. N.Y. Cmty. Bancorp Inc.*, No. CV-03- 5837, 2005 WL 2105810 (E.D.N.Y. Aug. 31, 2005) action voluntarily dismissed following passage of the EIPA (Dec. 3, 2008.)

37. N.Y. CPLR 5205(L)(1), 5222(H) (effective Jan. 1, 2009).

38. N. Y. CPLR 5205(L)(1), 5222(H) (effective Jan. 1, 2009)

39. N.Y. CPLR 5222(I) (effective Jan. 1, 2009).

40. Id.

41. N. Y. CPLR 5222(H) and (I) (effective Jan. 1, 2009).

42. N.Y. CPLR 5222-a (effective Jan. 1, 2009).

43. N.Y. CPLR 5240. The creditor's objection motion must be made within eight days of the debtor's service of the exemption form upon the creditor. N.Y. CPLR 5222-a (effective Jan. 1, 2009).

44. N. Y. CPLR 5222-a(e) (effective Jan. 1, 2009).

45. N.Y. CPLR 5222-a(g) (effective Jan. 1, 2009)

46. N.Y. CPLR 5222(b)

47. N.Y. CPLR 5230 and 5232.

48. N.Y. CPLR 5222-a(a) (effective Jan. 1, 2009).

49. N.Y. CPLR 5222-a(c)(5) (effective Jan. 1, 2009).

50. N.Y. CPLR 5222(c) (effective Jan. 1, 2009).

51. Supra notes 33, 34 and accompanying text.

52. N.Y. CPLR 5222(j) and 5232(f) (effective Jan. 1, 2009).

53. Baribeau, Simone "Direct Deposit of Social Security Checks: Safe, Fast B and Disastrous. As Federal Agencies Push for Recipients to Use Direct Deposit, Consumer Advocates Warn of Risks," The Christian Science Monitor, March 14, 2007.

54. N.Y. CPLR 5205(L)(3) (effective Jan. 1, 2009).

55. Conn. Gen. Stat. 52-367b(c).

56. The EIPA includes bad faith penalties to deter meritless creditor objections. Supra note 45.

57. "Protecting Social Security Benefits From Predatory Lending and Other Harmful Financial Institution Practices," Hearing before the Subcommittee on Social Security, Committee on Ways and Means, U.S. House of Representatives (June 24, 2008) (prepared statement of National Consumer Law Center, Margot Saunders, Counsel).

58. States other than New York that have enacted rules or legislation to protect exempt deposits are: Connecticut (Connecticut General Statutes 52-367b, (amended 2002)); Pennsylvania (Pennsylvania Civil Procedure Rule 3111.1 (Effective April 7, 2007)); and Alabama (Unified Judicial System, Form C-21 Rev. 11/06 ("Process of Garnishment") (effective November 2006). The states that failed to amend their laws despite efforts are Maryland, Virginia, and Nebraska.

59. The Committee on Finance, U.S. Senate held a hearing on Sept. 20, 2007 entitled "Frozen Out: A Review of Bank Treatment of Social Security Benefits." The Committee on Ways and Means held a hearing on June 24, 2008 entitled "Protecting Social Security Beneficiaries From Predatory Lending and Other Harmful Financial Institution Practices."

60. Proposed Guidance on Garnishment of Exempt Federal Benefit Funds 72 Fed. Reg. 55273 (Sept. 28, 2007.)

61. Bank of America, Comments regarding Notice of Proposed Guidance on Garnishment of Exempt Federal Benefit Funds (OCC: Docket ID OCC-2007-0015; Board: Docket No. OP-1294; TS: ID OTS-2007-0018), Nov. 27, 2007; JPMorgan Chase, Comments regarding Notice of Proposed Guidance on Garnishment of Exempt Federal Benefit Funds OCC Docket ID No. OCC-2007-0015 FRB Docket No. OP-1294, Nov. 27, 2007.

For others who support a bright-line rule, see The American Bankers Association, Comments regarding Notice of Proposed Guidance on Garnishment of Exempt Federal Benefit Funds, (OCC: Docket ID OCC-2007-0015; Board: Docket No. OP-1294;OTS: ID OTS-2007-0018). Nov. 27, 2007; PNC Financial Services Group, Comments regarding Notice of Proposed Guidance on Garnishment of Exempt Federal Benefit Funds, (OCC: Docket ID OCC-2007-0015; Board: Docket No. OP-1294;OTS: ID OTS-2007-0018). Nov. 27, 2007.