New Regulation Requires Financial Institutions to Protect Federal Benefit Payments in Deposit Accounts

February 28, 2011

New Regulation Requires Financial Institutions to Protect Federal Benefit Payments in Deposit Accounts from the Reach of Creditors

A new federal regulation that is intended to protect Federal benefit payments held in deposit accounts from the reach of creditors will impose significant new requirements on financial institutions. Effective as of May 1, 2011, financial institutions served with certain forms of legal process seeking to restrain or seize funds in a customer's deposit account will have to determine whether such account contains certain Federal benefit payments (such as Social Security), and if it does, to exempt certain funds from restraint and seizure and to notify the customer that the legal process has been received.

Background

Certain Federal benefit payments are exempt from garnishment and the claims of judgment creditors, such as Social Security benefits, SSI benefits, VA benefits, Federal Railroad retirement benefits, Federal Railroad unemployment, and sickness benefits, Civil Service Retirement System benefits and Federal Employee Retirement System benefits. This legal protection continues after such benefits are deposited in an individual's account at a financial institution.

Despite this legal protection, creditors and debt collectors have been able to restrain and seize benefit payments in deposit accounts as financial institutions have generally not been required under federal law or regulation to determine if the funds in an account are exempt from the reach of creditors. (Although, as discussed in Section 3 below, New York State adopted statutory amendments that took effect in 2009 addressing this issue.) This new regulation adopted by the Department of the Treasury is designed to give account holders certain protections against having these Federal benefit payments restrained or seized.

Requirements Imposed on Financial Institutions

Under the new regulation, a financial institution that receives a garnishment order must first determine if the United States or a state child support enforcement agency is the plaintiff that obtained the order. If so, the financial institution follows its customary procedures for handling the order and the requirements of the regulation will not apply. If not, the financial institution must review the account history for the prior two-month period to determine whether, during this "lookback period," one or more exempt Federal benefit payments were directly deposited to the account. The financial institution may rely on the presence of certain ACH identifiers to determine whether a payment is an exempt Federal benefit payment for purposes of the regulation.

The financial institution must allow the account holder to have access to an amount equal to the lesser of the sum of exempt Federal payments directly deposited to the account during the lookback period or the balance of the account on the date of the account review (the "protected amount"). In addition, the financial institution must notify the account holder that the financial institution has received a garnishment order. The notice must briefly explain what a garnishment is and must also include other information regarding the account holder's rights. There is no requirement to send a notice if the balance in the account is zero or negative on the date of account review. Financial institutions using the model notice issued by the Department of the Treasury will be deemed in compliance with the notice content requirements (a copy of that notice is attached hereto).

For an account containing a protected amount, the financial institution may not collect a garnishment fee from the protected amount. The financial institution may only charge a garnishment fee against funds in the account in excess of the protected amount and may not charge or collect a garnishment fee after the date of account review. Financial institutions that comply with the rule's requirements are protected from liability.

Protection of Exempt Funds Under New York State Law

As noted in Section 1 above, amendments to New York State law that took effect in 2009 imposed requirements on financial institutions to protect certain exempt funds from restraint and seizure by creditors. Those amendments, among other things, require financial institutions to determine if there was a direct deposit or electronic payment of funds exempt from creditors under New York State law within the 45 days preceding the receipt of a restraining notice or levy. If there was such a deposit, and the account has more than $2,500, only the amount over $2,500 is subject to the restraint or levy. The amendments also imposed additional requirements for protecting wages held in deposit accounts.

Although the new regulation provides that any state or local government law that is inconsistent with a provision of the new regulation is preempted to the extent of the inconsistency, it is unlikely that the provisions of New York State law protecting exempt funds will be deemed preempted. State law or regulation is inconsistent if it requires a financial institution to take actions or make disclosures that contradict or conflict with the requirements of the new regulation or if a financial institution cannot comply with the state law or regulation without violating the new regulation. The New York State Banking Department indicated last year in a comment letter supporting the new regulation that financial institutions can comply with both New York State law and the federal regulation.

Please note that the New York State amendments apply to a broader list of exempt payments than the new regulation issued by the Department of the Treasury. The new regulation just applies to the Federal benefit payments identified in Section 1 above, while the New York State requirements also apply to certain forms of public assistance, workers' compensation payments, unemployment insurance, and pensions. Accordingly, financial institutions will need to fully comply with the New York State requirements to the extent there are any exempt payments in an account other than the specific Federal benefit payments protected by the new regulation.

To the extent a deposit account contains exempt Federal benefit payments protected under both the new regulation and New York State law, then the safest course of action for a financial institution will be to comply with the requirements of both the new regulation and New York State law. This means protecting the highest amount required under both the new regulation and New York State law, and providing the required notices and following the required procedures under both provisions. This recommendation may change based on further regulatory or statutory amendments or regulatory guidance.

Further Information

Please note that this advisory is a general overview of the new regulation and is not intended as a comprehensive explanation of all aspects of the regulation or as formal legal advice. For further information regarding the regulation, please feel free to contact Joseph D. Simon at 516-357-3710 or via email at jsimon@cullenanddykman.com

Practices

- Regulatory and Compliance
- Banking and Financial Services

Industries

- Financial Institutions

Attorneys

- Joseph D. Simon