Dead but not Done: The Outdated Designation of Beneficiary

RISK MANAGEMENT PRACTICE GUIDES
OF LAWYERS MUTUAL

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Dead but not Done: The Outdated Designation of Beneficiary

The issue of what happens with retirement or life insurance benefits when a divorced spouse dies before changing the beneficiary designations creates confusion for everyone involved.

Family law and estate planning practitioners face this issue frequently.

To help prevent problems, properly following up on the beneficiary status for engagements concerning divorces or recently divorced clients.

Advising your client early can save you headaches down the road.

HOW TO USE THIS GUIDE

This Lawyers Mutual Practice Guide will help you maximize the rewards and minimize the risks of proper beneficiary designation in cases. It is designed as a tool for firms that practice family law or estate planning or look to practice in these areas in the future.

Here are some suggested uses:

- To instruct attorneys on legal ethics and risk management.
- To develop staff hiring criteria.
- To help with staff orientation.
- To help with staff training.
- To use as a topic at a firm meeting or retreat.
- To use as curriculum for in-house continuing education.

This Guide offers general information that should benefit most practices. It is not intended as legal advice or opinion, nor does it purport to establish a specific standard of care for your practice.

Every law office is different. Your cases are unique. This Guide suggests ways to bring out the best in your engagements.

For more information – or if you have additional questions – please contact Lawyers Mutual's Client Services Team.

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INTRODUCTION

What happens to retirement or life insurance benefits when a divorced spouse dies before changing the beneficiary designations? This unintended situation arises frequently, and it creates confusion for everyone involved. Consider this scenario:

> *Scott and Erika separated in 2006 and subsequently entered into a separation agreement. Under the agreement, Scott expressly waived his right and claim to any funds in Erika's 401(k) plan and to the proceeds of Erika's group life insurance policy. Scott and Erika's 2008 divorce decree incorporated the terms of their separation agreement by reference. Erika died in 2011 without ever removing Scott's name as the beneficiary of the funds from both her 401(k) and her group life insurance policy. Following Erika's death, both Scott and Erika's Estate claimed ownership of the funds. See Andochick v. Byrd, 709 F.3d 296 (4th Cir. 2013).*

Which party is entitled to the 401(k) and life insurance plan proceeds – Scott or Erika's Estate? Unfortunately, this is a common problem without a clear answer. Separation agreements often allocate individual and group life insurance, pension, and retirement plan benefits between separating spouses. That type of division is one of the main purposes of a separation agreement in effectuating an equitable distribution in accordance with Chapter 50 of the North Carolina General Statutes. But, the hard work does not end by simply executing the separation agreement. Had Erika ensured that a Qualified Domestic Relations Order (QDRO) was entered confirming – by court order – the allocation of the retirement plan benefits would have been honored. *See* I.R.C § 414(p). QDROs are generally used in situations such as Erika's to assign a portion or portions of pension and retirement plan benefits between separating spouses. Alternatively, Erika could have updated her 401(k) and life insurance beneficiary designations, and the terms of their separation agreement would have been honored without a hitch.

What happens; however, if one of the ex-spouses dies before those additional steps have been completed? Is the surviving ex-spouse or the estate of the deceased spouse entitled to the benefits? The result may surprise you, especially if the benefits are governed by the Employee Retirement Income Security Act of 1974 (ERISA). Although, the nuances of ERISA are not addressed in this article, in broad terms, ERISA governs private employers' group benefit plans. Government plans are excluded from ERISA coverage but usually are governed by comparable statutory schemes. Individual benefits, such as an Individual Retirement Account (IRA) or individual life insurance policies are not covered by ERISA and typically are controlled by state contract law.

ERISA benefits will usually be distributed to the beneficiary designated under the plan documents despite conflicting provisions in a separation agreement. The rightful beneficiary of non-ERISA benefits, as well as previously-distributed ERISA benefits, is far less certain. This uncertainty can be eliminated through mindful drafting and continued client counseling.

REFERENCES

- *Andochick v. Byrd*, 709 F.3d 296 (4th Cir. 2013)
- I.R.C § 414(p)
- Employee Retirement Income Security Act of 1974

BENEFITS STEMMING FROM PLANS GOVERNED BY ERISA

Generally, federal ERISA law and regulations preempt state law and govern the design and administration of private employers' group benefit plans. Thus, an ERISA plan's designation of a beneficiary would trump a contrary beneficiary designation memorialized in a separation agreement, equitable distribution judgment, or divorce decree. This point was made painfully clear by the U.S. Supreme Court in *Egelhoff v. Egelhoff*, in which the deceased husband had divorced and died intestate two months later, without ever changing his beneficiary designations. 532 U.S. 141, 121 S. Ct. 1322, (2001). The ex-wife received all of the deceased husband's life insurance and pension. His children from a previous marriage were his statutory intestate heirs. A Washington statute provides that the designation of a spouse as beneficiary of non-probate assets is revoked automatically by divorce. The children filed suit against the ex-wife, contending that they were the rightful beneficiaries under Washington law. The case found its way to the Supreme Court, which concluded that the Washington statute is preempted by ERISA, and that the ex-wife properly received the plan benefits.

A key factor controlling the distribution of ERISA benefits is whether the claim relates to pre-distribution or post-distribution benefits. In *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan*, the decedent, William, participated in his employer's ERISA-governed savings investment plan under which he had the power to designate a beneficiary. 555 U.S. 285 (2009). William designated his wife, Liv, as the beneficiary. William and Liv later divorced and, pursuant to the terms of the divorce decree, Liv was divested of her interest in William's employee benefit plan proceeds. William died without ever designating a plan beneficiary other than Liv. Upon notice of William's death and in accordance with the designation of beneficiary in his plan documents, the plan administrator distributed the savings plan benefits to Liv. William's Estate filed suit against the plan administrator to recover the savings investment plan benefits, contending that Liv was divested of her interest in the benefits pursuant to her waiver of those benefits under the terms of the divorce decree.

The Supreme Court ruled in favor of the plan administrator, holding that in the absence of a QDRO, DuPont was required to follow the terms of the plan, which called for the distribution of plan benefits to Liv. This ruling aligns with the ERISA objective to ensure uniform administration, which requires a plan administrator to distribute plan proceeds in accordance with plan documents without the necessity of examining documents outside of the plan. However, a properly executed QDRO can alter this result by requiring a plan administrator to allow the assignment of pension or retirement benefits outside of the plan. *See* 29 U.S.C. § 1056(d)(3). The Supreme Court in *Kennedy* declined to decide whether ERISA would preempt a state law waiver after the benefits had been distributed. This left the door open for post-distribution claims by an estate administrator against the recipient to "capture" benefits paid in a manner that contradicted the separation agreement or divorce decree.

Admittedly, the estate administrator's remedy of seeking post-distribution recovery of the benefits in a direct action against the ex-spouse is cumbersome and fraught with uncertainty. Erika's Estate pursued this remedy when her 401(k) ERISA-governed benefits were distributed to Scott. Scott disagreed, claiming, among other things, that ERISA preempted any remedies against him by Erika's Estate. The Fourth Circuit was tasked with determining whether ERISA could preempt the claim made by Erika's Estate and ultimately protect Scott's receipt of benefits stemming from Erika's 401(k) and life insurance plans. In *Andochick v. Byrd*, upon notice of Erika's death, Scott claimed both the 401(k) and life insurance plan benefits as the designated beneficiary despite his previously-executed waiver of those benefits in the parties' separation agreement. 709 F.3d 296 (4th Cir. 2013). The administrator of the 401(k) plan distributed the benefits to Scott, but the administrator of the insurance policy announced its intention to file an interpleader action based on its inability to determine the rightful beneficiary of the proceeds. The Estate requested that Scott renounce his interest in the 401(k) and life insurance proceeds based upon his waiver contained in the separation agreement. Scott refused and, instead, filed a declaratory action in federal court for the Eastern District of Virginia, claiming that a state court's divorce decree distributing the ERISA plan proceeds was preempted by ERISA. Almost simultaneously, Erika's Estate obtained a state court order holding Scott in contempt of the separation agreement on the basis of the waiver and ordering him to disgorge the proceeds to the Estate.

In a Memorandum Opinion, the Federal District court held that the ERISA benefits were properly payable to Scott in accordance with the plan documents. *See Andochick v. Byrd*, Slip Copy (E.D. Va 2012). The court, however, declined to grant Scott's declaratory judgment action seeking to establish that ERISA preempted the waiver found in the separation agreement and terminated Erika's Estate's interests in the 401(k) and life insurance plan proceeds. The court held that "ERISA only controls the disbursement of the benefit proceeds at the plan administrator level." Id. Further, the court stated that "ERISA does not alter common law waivers or impede challenges against beneficiaries after they have received the initial payment as a beneficiary under the ERISA plan." *Id.*

On appeal, in *Andochick*, the Fourth Circuit answered the question left open by the Supreme Court in Kennedy, holding that "[a]llowing post-distribution suits to enforce state-law waivers does nothing to interfere" with the objectives of ERISA. Those objectives being "'[1] simple administration, [2] avoid[ing] double liability [for plan administrators], and [3] ensur[ing] that beneficiaries get what's coming quickly.'" The court also noted that although ERISA requires that plan beneficiaries 'get what's coming quickly,' ERISA does not guarantee that plan beneficiaries keep what came to them.

As such, although distributions must be made by ERISA plan administrators in accordance with plan documents or applicable QDROs, if any, "ERISA does not preempt post-distribution suits against ERISA beneficiaries" at the state level. So although Scott was the rightful beneficiary of the 401(k) and insurance plan proceeds pursuant to ERISA, ERISA does not preempt the separation agreement waiver or require that Scott remain the beneficiary in the face of the conflicting state law. Erika's Estate was forced to incur costly and timely litigation to obtain the benefits that seemed so clearly and simply governed by the separation agreement and divorce decree.

REFERENCES

- *Egelhoff v. Egelhoff*, 532 U.S. 141, 121 S. Ct. 1322, (2001)
- *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan,* 555 U.S. 285 (2009)
- 29 U.S.C. § 1056(d)(3)
- *Andochick v. Byrd*, 09 F.3d 296 (4th Cir. 2013)
- *Andochick v. Byrd*, Slip Copy (E.D. Va 2012)

FEDERAL EMPLOYEES' AND SERVICE MEMBERS' LIFE INSURANCE BENEFITS

Many federal employees are eligible for group life insurance under the Federal Employees' Group Life Insurance Act of 1954, 5 U.S.C. §8701 et seq. (FEGLIA). In a June 3, 2013 decision, the Supreme Court held that FEGLIA preempts any contrary state laws that might otherwise nullify an insured's designation of an ex-spouse as beneficiary. *Hillman v. Maretta*, 569 U.S. ____ (2013). The facts in *Hillman* are similar to *Andochick* and *Egelhoff*. In 1996, Warren Hillman, a federal employee, named his then wife, Judy Maretta, as the beneficiary of his FEGLI policy. Warren and Judy divorced in 1998, and he married Jacqueline Hillman four years later. He died in 2008 without ever changing his beneficiary from Judy to Jacqueline. A Virginia Statute revokes a beneficiary designation in any contract that provides a death benefit to a former spouse following a divorce, Va. Code Ann. §20-111(A). Where that provision is preempted by federal law, §20-111(D) provides a cause of action making the former spouse liable for the proceeds to the party who would rightfully have received them if Section A of the statute were not pre-empted. This Section D gave a remedy to Ms. Andochick's estate in recovering benefits provided under ERISA, but in Hillman, the court concluded that Section D interfered with the statutory scheme of FEGLIA, and therefore it is preempted. Thus, the ex-wife received the benefits.

In deciding *Hillman*, the court noted that the result was consistent with the result in two earlier Supreme Court rulings addressing other federal benefits. In *Wissner v. Wissner*, 338 U.S. 655 (1950), benefits provided under the National Service Life Insurance Act of 1940, 54 Stat 1008, pre-empted a rule of state marital property law. This case was followed by *Ridgeway v. Ridgeway*, 454 U.S. 46 (1981), holding that beneficiary designations under the federal Servicemen's Group Life Insurance Act of 1965, 79 Stat. 880, which creates an insurance scheme for armed services members, pre-empted state law.

REFERENCES

- Federal Employees' Group Life Insurance Act of 1954, 5 U.S.C. §8701 et seq.
- *Hillman v. Maretta*, 569 U.S. ____ (2013)
- Va. Code Ann. §20-111(A)
- Va. Code Ann. §20-111(D)
- *Wissner v. Wissner*, 338 U.S. 655 (1950)
- *Ridgeway v. Ridgeway*, 454 U.S. 46 (1981)
- Servicemen's Group Life Insurance Act of 1965, 79 Stat. 880

OTHER BENEFITS

State law governs the distribution of non-ERISA individual benefits, such as IRA accounts and private life insurance policies. Estate planners will recognize these as non-probate assets, meaning that they pass outside a decedent's estate according to the terms of the decedent's beneficiary designation. Although divorce has the effect of severing the interests of a wife to her husband's property rights and vice-versa, divorce does not alter the interests ex-spouses may have in each other's non-probate assets, which generally consist of individual and group life insurance, pension, and retirement plan benefits as well as payable or transferable on death accounts. *See* generally N.C.G.S. §§ 31A-1, 50-11. Rather, if Scott remains the named beneficiary of an individual life insurance policy or IRA account, they may be distributed pursuant to beneficiary designations, regardless of divorce. Although these types of assets are commonly addressed in separation agreements, the corresponding beneficiary designations are not always updated prior to the death of an ex-spouse. Under those circumstances, it is not always clear what the surviving ex-spouse is entitled to, especially if the ex-spouses remained friends after their separation.

Without a specific divorce decree or separation agreement incorporated into a divorce decree allocating non-probate assets between divorcing spouses, courts are often reluctant to alter beneficiary designations that call for distribution of benefits to an ex-spouse. Indeed, when disputes regarding the proper beneficiary arise, the ex-spouse typically will claim that the couple remained close following their divorce and that the decedent had always promised to take care of the ex following death. Regardless of the validity of these types of claims, the litigation costs of pursuing the claims can be exorbitant. These were the underlying facts in *Schwab v. McEntee*, ___ S.E.2d ___ (N.C. Ct. App. 2013), where Charles Schwab and Co. filed a declaratory judgment action to determine the rightful owner of IRA account proceeds. The decedent never changed the beneficiary following divorce, but the ex-spouse claimed that he had fully intended to leave her as the named beneficiary, despite contrary language in their separation agreement.

Courts typically view insurance and benefits contracts between an individual and the applicable life insurance company or financial institution as a contract designating a third-party as a beneficiary, such that the third-party's rights to benefits arise from the contract between an individual and the institution and remain unaltered by divorce between the individual and the third-party. *See Luszcz v. Lavoie*, 787 So. 2d 245 (Fla. Dist. Ct. App. 2d Dist. 2001). For courts unwilling to alter such a contract, one might expect the same result as under an ERISA plan, such that the institution distributes benefits to the designated beneficiary and allows the estate and designated beneficiary to then sort out the ownership issue, or that the institution might file an interpleader action, unwilling to risk distributing benefits to the incorrect party. Under either scenario, the terms of the applicable separation agreement become paramount to determining the rightful recipient of the benefits.

The failure of a decedent to change the named beneficiary following entry of a separation agreement or divorce historically arises in the context of a life insurance policy, and, in recent years, in the context of an IRA account. There, however, have been no reported North Carolina cases dealing with the distribution of an IRA account. This was the factual issue behind *Schwab v. McEntee*, but the court did not address the merits of that particular dispute. One of the key cases that addressed this issue, *Estate of Tremaine ex rel. Tremaine v. Tremaine*, held that the stipulation of the parties in their divorce decree stating that each spouse was entitled to an interest in any retirement account that each spouse had was ambiguous. 146 N.H. 674, 780 A.2d 522, (N.H. 2001), r*eh'g denied*, (2001). Because the divorce decree did not unambiguously change the ex-husband's beneficiary designation prior to his death, his ex-wife was entitled to the proceeds of her ex-husband's IRA account.

In North Carolina, cases examining designation of beneficiary issues have occurred in the context of life insurance claims. With one exception, *Myers v. Myers*, 714 S.E. 2d 194 (N.C. Ct. App. 2011), North Carolina appellate courts have uniformly upheld the validity of designation of beneficiary claims asserted by ex-spouses, despite the existence of a separation agreement stating or implying that the former spouse had waived any claim to the proceeds. Typical of these cases is *Daughtry v. McLamb*, where the decedent's estate contended that a divorce decree had the effect of nullifying a beneficiary designation naming the decedent's first wife. 132 N.C. Ct. App. 380, 512 S.E.2d 91 (1999). The court held that the first wife was entitled to proceeds of the life insurance policy, despite a provision in the divorce decree that "insurance ... arising out of [decedent's] employment" was awarded to the decedent. *Id.* at 382. The court noted that the decree did not specifically refer to life insurance, and no attempt had been made to change the beneficiary before the decedent's death, thus the beneficiary designation controlled. *See Id.*

Against this background, *Myers* presents procedural facts similar to Scott and Erika Andochick's. 714 at 194. In *Myers*, the court ordered that a minor child be named as the beneficiary of a life insurance policy as part of a divorce decree that incorporated terms of the separation agreement. The husband died without changing the beneficiary designation, but the court "captured" the proceeds by imposing a constructive trust on the proceeds.

Whether an estate's claim that the terms of a separation agreement are sufficient to override a beneficiary designation will likely depend upon a combination of factors including the specificity of the separation agreement, the intent of a waiver (if a waiver was included) and whether the terms of the separation agreement are broad enough to cover future expectancy or merely address present interest at the time the divorce decree is entered or the separation agreement executed. In *Maccabees Mutual Life Insurance Company v. Morton*, the court found that Diane's release of rights to "all claims, demands, accounts, powers of attorney and causes of action which [she] may have against [Charles] . . . as the . . . wife, widower, widow or next of kin, successor or otherwise" in the couple's separation agreement was not specific enough to override Charles' individual retirement account and life insurance beneficiary designations, which designated the Diane as the beneficiary. 941 F.2d 1181, 1184 (11th Cir.) (emphasis in original). This was so regardless of the court's recognition of the parties' clear intent to cause the Diane to release her interest in benefits of this type. In *Schultz v. Schultz*, the Iowa Supreme Court held that even a divorce decree that awarded ownership of a specifically identified individual retirement account to one spouse was insufficient to override an unchanged beneficiary designation for that account where the decree did not include language that severed the surviving ex-spouse's future expectancy to the benefits. 591 N.W.2d 212 (Iowa 1999).

REFERENCES

- N.C.G.S. §§ 31A-1, 50-11
- *Schwab v. McEntee*, ___ S.E.2d ___ (N.C. Ct. App. 2013)
- *Luszcz v. Lavoie*, 787 So. 2d 245 (Fla. Dist. Ct. App. 2d Dist. 2001)
- *Estate of Tremaine ex rel. Tremaine v. Tremaine*, 146 N.H. 674, 780 A.2d 522, (N.H. 2001), *reh'g denied*, (2001)
- *Myers v. Myers*, 714 S.E. 2d 194 (N.C. Ct. App. 2011)
- *Daughtry v. McLamb*, 32 N.C. Ct. App. 380, 512 S.E.2d 91 (1999)
- *Maccabees Mutual Life Insurance Company v. Morton*, 941 F.2d 1181, 1184 (11th Cir.)
- *Schultz v. Schultz*, 591 N.W.2d 212 (Iowa 1999)

PRACTICE POINTERS

Although a dispute over the rightful beneficiary of individual or group life insurance, pension, or retirement plan benefits in these instances may not be entirely avoidable, the following measures may be taken to lessen the likelihood that a dispute will ensue.

FOR FAMILY LAWYERS:

1. When dividing pension or retirement plan benefits between separating spouses, timely obtain a QDRO from the state district court. In many instances, the plan administrator will offer a pre-approval opinion as to whether the QDRO is properly drafted before it is entered by the court. Immediately after the QDRO is entered by the court, submit a certified copy of the QDRO to the plan administrator using certified mail, return-receipt requested to confirm delivery. Set a calendar reminder to follow-up with the plan administrator thereafter to verify that the proper allocation or distribution has been made in accordance with the QDRO. Consider including a clear directive in the separation agreement that states the parties' intention to obtain a QDRO to effectuate the division of the pension or retirement plan benefits and further directing that the failure to obtain a properly-filed QDRO does not in any way waive the parties' intent to divide the benefits.

2. Follow-up with your client to ensure that he or she has updated all applicable beneficiary designations, removing his or her ex-spouse as a beneficiary if allowed by the terms of the separation agreement. If possible, retain a copy of the updated beneficiary designation for your file. Certainly document your client's file with your reminder, preferably in writing to the client.

3. In drafting a waiver or release of rights in a separation agreement, be sure to make specific reference to each benefit that contains a beneficiary designation to make it clear that the parties' intention to waive or release rights applies to the right to designate beneficiaries in addition to the right and entitlement to the asset itself. Also, indicate that the waiver or release applies to both an ex-spouse's present interest as well as future expectancy in the benefits. Even if specific language is used in a separation agreement to waive an ex-spouse's right to his or her present interest and future expectancy of benefits, a surviving ex-spouse might still argue that those benefits were a gift intended to be given to the ex-spouse subsequent to the divorce. Perhaps the solution here is to include language that, absent a specific written testamentary or other gift provision, all future expectancy of benefits are waived and shall not be treated as a gift. Alteration of this language would require a separate agreement of the parties.

FOR ESTATE PLANNERS:

1. When meeting with a recently-divorced client seeking to update his or her estate planning documents, be certain to explore whether they have life insurance, retirement funds or other non-probate assets the distribution of which would be governed by a designation of beneficiary with the plan administrator, fund manager or insurer.

2. Remind the client to update his or her beneficiary designations for all individual or group life insurance, pension, and retirement plan benefits as well as payable or transferable on death accounts. Certainly document your client's file with your reminder, preferably in writing to the client.