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The Effect of Divorce on Life Insurance Beneficiary Designations

Beneficiary designations are among the most important aspects of financial planning with life insurance. All too often, circumstances change but beneficiary designations do not, frustrating the policyholder's post-death objectives. Advisers should, therefore, be aware of the effects of major life changes on life insurance, specifically beneficiary designations.

Common, almost expected, as it is in today's society, divorce remains among the most significant of those life changes. This Current Comment examines the effect of divorce specifically on beneficiary designations. The discussion falls sharply into two parts, ERISA governed Plans and non-ERISA governed Plans.

ERISA-Governed Plans after Egelhoff

In Egelhoff the Supreme Court held that a Washington statute that voided an ex-spouse's beneficiary designation upon divorce was preempted by ERISA. Therefore, policies subject to ERISA, such as those issued pursuant to a qualified plan, must be discussed separately.

The doctrine of Egelhoff could be expected to have a pernicious effect: an insured could have the clearest intention of changing the beneficiary and fail to achieve that intention because the beneficiary designation had not been changed pursuant to the plan. Lower courts seem to have sensed the potential injustice and have looked for ways to get around Egelhoff since it was decided.

It should first be noted that ERISA preemption of beneficiary designations is not absolute. ERISA contains an explicit exemption for qualified domestic relations orders (QDROs). See 29 U.S.C. §1056(d)(3)(A). A QDRO is a domestic relations order that meets conditions set forth at I.R.C. §414(p) and that creates or recognizes the existence of an alternate payee's right to, or assigns an alternate payee the right to, receive all or a portion of the benefits payable to a participant under a plan. See Section 17, Subdivision P of this Service for QDRO details. Thus, if a court finds that the divorce decree pursuant to which the beneficiary is changed is a QDRO, the order escapes preemption. Boggs v. Boggs, 520 U.S. 833 (1997).

If the order is not a QDRO, the courts have found several ways to hold that nevertheless, it is not preempted by ERISA. One court held that the ERISA beneficiary had implicitly waived his beneficiary rights by entering into an agreement that made the benefits payable to someone else; another held that the terms of the ERISA-governed plan themselves allowed the divorce decree to constitute a waiver.

An alternative way some federal courts have adopted to get around Egelhoff is to hold that ERISA indeed preempts state law (such as the redesignation statutes) and creatures of state law (such as changes of beneficiary by will), but that state law can nonetheless be adopted as "federal common law." This is a doctrine, beloved by law professors, according to which federal courts can use state law, for example, to fill gaps in federal statutes. There is no need to go into detail: it's enough to observe that most of the federal courts of appeals that have considered the issue—the Fourth, Fifth, Seventh, and Eighth—have taken this route, and only the Sixth has clearly rejected it.

In this respect an interesting case is the Texas Supreme Court's decision in Keen v. Weaver, 121 S.W.3d 721 (2003). The Texas intermediate court found against the ERISA beneficiary in spite of Egelhoff. It said that even though under Egelhoff, Texas's redesignation statute (similar to Washington's) was preempted, that very statute could be adopted as federal common law. This is a little too blatant an end run around Egelhoff, and the Texas Supreme Court found instead that the ERISA beneficiary specifically, knowingly, and voluntarily waived her right to the plan proceeds in the divorce decree—and that these criteria for waiver had been adopted by the federal courts of appeals, would not interfere with the uniform administration of ERISA, and thus were compatible with Egelhoff.

On the other hand, some courts have felt compelled to follow and even expand Egelhoff (e.g. Jones v. Jones, 2001 Del. Fam. Ct. LEXIS 2 (Del. Fam. Ct. 2001) (Egelhoff preempts state law that was violated by change of beneficiary designation in plan); Barnett v. Barnett, 67 S.W.3d 107 (Tex. 2001) (Egelhoff preempts Texas state community property laws—a decision by the very Texas Supreme Court that was later concerned to uphold waiver in Keen).

The upshot for advisers? There is no need to bone up on the arcane of federal preemption doctrine. Instead, advisers should simply make sure that any qualified plan beneficiary redesignation is taken care of as soon as possible—preferably before the divorce is even finalized. The courts may sympathize with a plan participant whose intentions could be frustrated by Egelhoff, but it would be foolish to count on it. As noted in this Service's other discussions, even the most conscientious adviser can't force the client to complete a new beneficiary designation, but the adviser must at least try.

Non-ERISA-Governed Policies

Since Egelhoff only applies to ERISA-governed plans, a life policy that is not contained in such a plan is unaffected by the decision. For such policies, the effect or lack of effect of divorce on the beneficiary designation is a matter of state law.

Effect (or Lack Thereof) of Divorce Per Se - Redesignation Statutes

In particular, state redesignation statutes are not preempted with respect to non-ERISA-governed plans; in states that have such statutes, such as Washington, Texas, Michigan, Virginia, Oklahoma, Pennsylvania, and Kentucky, divorce extinguishes the designation in favor of the divorced spouse in non-ERISA policies. Advisers should know, therefore, whether their state has such a statute even after Egelhoff.

The General Principle: No Automatic Change

It's especially important for advisers to know about redesignation statutes because in the absence of such a statute the mere fact of divorce is not sufficient to change the beneficiary designation in the majority of states. As a general principle, a beneficiary change can only be made according to the procedures specified by the policy itself. (That's exactly why problems arise with beneficiary designations after divorce.) With one exception, action—by the court or the parties—has to be taken to change the beneficiary. That exception arises when the policy itself contains a provision that voids the designation, generally formulated as a requirement that the beneficiary is ineligible if he or she does not have the status of spouse at the insured's death.

An interesting case is Hughes v. Scholl, 900 S.W.2d 606 (1995), predating the Kentucky redesignation statute (Ky. Rev. Stat. Ann. §61.542), which took effect in 2004. The divorce decree in Hughes contained a "mutual release" that did not address insurance policies on the husband's life (a mistake advisers should never allow to happen, as discussed below). When the husband died, the wife claimed the proceeds, citing Kentucky precedent; the estate argued that the court should create a rebuttable presumption that divorce eliminates the former spouse as beneficiary. The court rejected this idea and hewed to precedent. It noted that this didn't mean a properly drafted provision in the divorce decree could not change the beneficiary. In this case, however, a general mutual release was not enough. Had the case arisen ten years later, the new redesignation statute would have ensured a different result.

Waiver in Non-Egelhoff Cases

In non-Egelhoff cases, waiver is a frequent issue. Divorce decrees frequently contain clauses in which each spouse waives all rights in the property of the other. Does such a general waiver succeed in extinguishing the beneficiary spouse's beneficiary rights?

The answer is no. The general rule is that a waiver of rights must specifically mention an insurance policy to be effective as to that policy, especially where beneficiary designations are concerned. Two related theories are usually advanced by the courts. First, beneficiary rights are a

matter of the insurance contract, not the marriage relationship, so a waiver of marital rights can't affect the beneficiary designation. See, e.g., Mullenax v. National Reserve Life Insurance Co., 29 Colo. App. 418, 485 P.2d 137 (1971). Second, the beneficiary's interest in the property is a mere expectancy, not a full-blown property interest, and therefore cannot be relinquished by the beneficiary's waiver of property rights. Mullenax, supra.

Some courts, however, do try to determine the parties' intention and to give it effect even in the case of a general waiver that does not specifically mention a life insurance beneficiary designation. The courts that do this use such criteria as whether the policy owner had an opportunity to change the beneficiary designation but did not; whether there were any representations that the beneficiary status would not be changed; whether the parties remained friendly after the divorce. Unfortunately, it is clear that these are not reliable indicators of an intent to leave the designation undisturbed. After all, pretty much every case involves a decedent who had an opportunity to change the beneficiary designation but did not.

Conclusion

When divorce happens, there is no substitute for a change of beneficiary designation by the insured on the policy itself made according to the method prescribed by the insurer as contained in the policy. The insured might live in a state with a redesignation statute and the policy might not be contained in a qualified plan, so that Egelhoff is not implicated; but in every other situation there are likely to be problems. Advisers should be aware that divorce by itself does not affect the beneficiary designation and that a general waiver in the divorce decree will not either. They should make every effort to ensure that the designation is changed even before the divorce is finalized. There's really no other way to be absolutely sure.

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