Employee Benefits Alert

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QDROs Continue to Cause Divorce Lawyers Fits

A recent Appellate Court case regarding the distribution of a pension plan's death benefit demonstrates the sacred nature of ERISA protections afforded to retirement plan participants and beneficiaries. Applicable rules governing recognized ERISA exceptions to those requirements must be carefully followed if such exceptions are to be respected. That is particularly true as they relate to distributions pursuant to qualified domestic relations orders ("QDROs").

Normally, a plan's death benefit distribution provision automatically prevails. Participants are permitted to designate death benefit beneficiaries — but only with spousal consent. That rule also applies to any other qualified plan distribution. Generally, distributions from a qualified plan under ERISA and the Internal Revenue Code (the "Code") must go to the participant, unless the participant is deceased.

Over the years these ERISA requirements have caused problems for retirement plans because in many divorce situations the retirement plan is the largest and most important marital asset. Retirement plan proceeds are often the source of pitched divorce battles because the proceeds appear to be much more liquid than the other large asset of most people — their home. To the contrary, divorce lawyers and their clients have found, pension plan assets generally lack liquidity. They typically can not be distributed to anybody other than individuals named in the plan except with spousal consent — and even then, only on occasion of the plan's distributable events. Distributable events generally include:

- Employee reaching age sixty-five
- Termination of service
- Death
- Disability
- Early distributions in the event of early retirement under certain plans.

In many cases divorced spouses did not want to wait until the participant turned age sixty-five and consequently tried to obtain their distributions early. Unfortunately, ERISA rules and tax code requirements prevented such maneuvers. As a result, court orders from judges were regularly frustrated by plan administrators' insistence on adhering to plan terms in order to avoid plan disqualification under the Code. Those rules were changed during the '80s to enable divorced spouses to obtain a court order that would permit them to obtain a distribution from the plan (even though they were no longer the spouse of the participant) and in some cases to secure the distribution earlier than would otherwise be available. However, noting that ERISA spousal protections exist for a reason, Congress made the availability of such distributions subject to many complex rules in order to ensure that the parties were fully aware of what they were doing. In addition, the rules were also enacted to protect the plan sponsor responsible for administering the plan.

Although most employers would prefer that participants, their spouses, and their attorneys work out their differences among themselves — that does not always occur. Moreover, because the plan and its fiduciaries must administer an ERISA plan according to its terms, the plan must take an active role in determining whether a QDRO meets the requirements necessary for a distribution (pursuant to the QDRO's instructions) or whether the plan's regular terms prevail.

Early on, many divorce lawyers seemed unable to figure out how to draft QDROs in a way that would satisfy plans and plan administrators. This meant that large numbers of QDROs would be rejected and returned again to be rewritten. In many cases plan sponsors were saddled with huge legal bills from outside counsel who repeatedly reviewed incoming QDROs trying to help the divorce lawyers draft them in a manner that enabled plans to comply with their terms.

Over the years, as available options became clearer and the rules better known, fewer disputes over how the QDROs could be drafted seemed to surface. One key improvement is that plans began insisting on usage of standardized plan forms which made it much easier for the divorce lawyers. However, many lawyers still struggled figuring out how to divide benefits under traditional pension plans — as life annuities are usually considered more difficult to understand than account balance plans such as 401(k) plans.

Nevertheless, sometimes despite the best intentions of everybody involved, plan benefits are split up pursuant to a divorce order and presented to the plan *after the fact*. The central requirement for ERISA plans to consider therefore depends on QDRO validity. If the order is not determined to be a QRDO the plan must follow its terms and reject the purported QDRO — unless it wants to find itself in the position of possibly making the payments twice. The following case illustrates the consequences of failing to make sure the order is determined, by the plan, to be a QDRO.

QDROS: Specificity Required

Hamilton et al. v. Washington State Plumbing & Pipefitting Industry Pension Plan et al., Nos. 04-35526, 04-35828, 04-35798 (Ninth Circuit, January 10, 2006), involved a QDRO that purported to provide certain pension plan death benefits to a participant's children.

Facts

Michael Hamilton participated in several pension funds that were all considered defined benefit pension plans subject to ERISA. Michael and his first wife, Linda, divorced in April, 1996. Pursuant to that divorce a state court filed an order that required Michael to:

> "Name the children of the marriage, David and Sarah, as the beneficiaries under the pension in lieu of life insurance which he is presently unable to obtain, which obligation shall terminate when the youngest child reaches eighteen years of age."

There was apparently no separate order deemed or designated to be a QDRO. Michael remarried quickly after the divorce and named his new wife, Mary, as the beneficiary of the death benefits under his pension plans. Michael died in a car accident six years later at the age of forty-nine.

At the time of his death Michael was still married to Mary and the children of his prior marriage were still under the age of eighteen. Although not yet retired and not receiving any pension benefits, he was fully vested in his retirement plans. Following Michael's death, the children of his first marriage came forward to claim their father's benefits pursuant to the divorce court order, but Mary claimed that she was entitled to the benefits as the surviving spouse. Although the district court judge found that the initial divorce dissolution agreement (quoted above) was a valid QDRO, the Appeals Court held differently and unfortunately for the children, found in favor of Mary as the surviving spouse because the order was not a QDRO.

Court Holding

The Ninth Circuit Court spent many pages describing the requirements of a qualified plan and the necessary elements needed to establish the technical ERISA exception needed for an order to be considered a valid QDRO. The court held that a valid QDRO must meet all the requirements set forth in the prescribed exception Congress enacted, in order for it to be recognized. A QDRO must therefore satisfy numerous elements in order to be considered valid. Key elements include the following:

- The order must specify the name and last known mailing address of an alternate payee and the affected plan participant,
- The amount or percentage of the participant's benefits to be paid or the means by which the amount will be determined,
- The number of payments or time period to which the order applies,
- Each plan to which the order applies.

Moreover, the QDRO may not:

- Require the plan to provide any type of benefit not otherwise provided,
- Require the plan to provide increased benefits, or
- Require the benefits to be paid to an alternate payee which must be paid to another alternate payee under another QDRO.

The Court held that the divorce court's vague reference to the pension and the children failed to satisfy QDRO requirements. The Court cited other problems as well. For example, there was no plan requirement to assign a death benefit, it did not specify when such a benefit or payments would begin, it did not specify the amount of the benefit or how to calculate the benefit, nor any other of the specific

requirements necessary. The Court also observed that the details missing from the divorce court's order were not just technical hurdles that could be casually dismissed. In the Appeals Court's view, these various ambiguities rendered the divorce court's decree unclear and unenforceable.

In addition, the Court found that the surviving spouse (Mary) also enjoyed protective rights under the tax code. In order to divest the surviving spouse of her rights under a pension plan (the right to a preretirement survivor annuity that all pension plans must provide), any purported QDRO must specifically state that it is divesting any future spouses of that benefit and is instead providing that benefit to the divorced spouse or other beneficiaries. A valid QDRO must explicitly assign those rights to a former spouse — and because the divorce decree failed to do so in this case, Mary prevailed.

The Court went on to comment that not only should ERISA's statutory requirement prevail, but in this particular case application of the pension plan document's own rules would lead to an identical conclusion. The purported QDRO did not meet the specific requirements under the statute, it did not explicitly divest the surviving spouse of her rights, nor did it even follow the terms of the plan itself. Therefore, the Court held that the children were not entitled to the benefits under the plan, despite the order of the divorce court. The Court further stated that the surviving spouse, Mary, was entitled to all of the plan's death benefits.

Conclusion

Although this outcome might seem harsh given the intent of the participant and his first spouse, it's important to consider the fact that the participant (Michael) did not follow through on his end of the bargain. Had the participant followed through with processing the divorce court's order, the results in this case may have been quite different. Nevertheless, the key point for plan sponsors to note is that an ERISA plan is legally precluded from complying with an order that is not a QDRO. Moreover, in this case the plan would have put itself in a difficult position had it tried to reconcile the ambiguous requirements of the divorce court order and pay the benefits to the children rather than the surviving spouse.

Under the terms of ERISA, the Code, and the plan itself, the plan must follow the terms under which it is written. Those terms clearly required that the surviving spouse receive the death benefit unless the benefit has been specifically provided to an alternate payee pursuant to a QDRO. This order was not determined to qualify as a QDRO, so the plan was forced to pay the benefits to the employee's surviving spouse. The children were not able to recover under the terms of the plan. [*Note:* Although we acknowledge that the children might have a valid claim against the divorce lawyer's malpractice policy to recover those benefits since that lawyer did not properly reduce the terms to an enforceable QDRO, a detailed discussion of the merits of those possible claims stretches beyond the scope of this article.]

Finally, the purpose of this discussion is to remind plan administrators that they need to exercise special care when they are presented with a purported QDRO. If the plan administrator in this case had made a distribution to the children pursuant to the divorce court's order, the outcome would have been very different for the plan. The surviving spouse would have had a claim against the plan and, according to the Ninth Circuit Court, would have been entitled to the death benefit payment. The plan might have then been forced to sue the children and try to recover payment, or live with the fact that it had to make the payment twice. (Note: Paying the claim twice would itself present technical ERISA compliance problems.) So, despite over twenty years of experience with QDROs, a lower federal court got the rule wrong and the plan sponsor had to go to the Court of Appeals to obtain an appropriate decision.

The Ninth Circuit includes: Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam, and the Northern Mariana Islands.

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