TAX & ESTATE PLANNING

Illinois Court Decision Highlights Critical Importance of Updating Beneficiary Designations Post-Divorce

By Ted A. Koester

INTRODUCTION

A case recently decided by the Illinois Appellate Court (*Herbert v. Cunningham*, 2018 IL App (1st) 172135, December 28, 2018, Cook Co., 6th Division) issues an important reminder to anyone who is considering or has completed a journey through divorce or domestic separation: Make sure to update your estate plan documents, beneficiary designations and the titling of your assets after the divorce has been finalized.

CASE SUMMARY

In *Herbert v. Cunningham*, the decedent's ex-spouse sought to claim ownership of the decedent's 401k plan account after the decedent's employer and 401k plan trustee distributed the 401k plan funds to the estate. It was the opinion of the executor and the employer-trustee of the 401k plan that the account should pass to the decedent's estate based on the divorce agreement. However, because the decedent did not take steps after his divorce to remove his ex-spouse as the designated beneficiary of his 401k plan, the ex-spouse objected. Her claim was based on the Employee Retirement Income Security Act of 1974 ("ERISA"), which mandates that plan administrators and trustees distribute one's plan account to the beneficiary or beneficiaries who are named at the time of the owner's death.

The Court agreed with the executor in the *Herbert* case and ruled that the 401k at issue belonged to the decedent after the divorce. One of the key factors in the *Herbert* decision was that the executed divorce settlement agreement contained a very broad release provision in which both spouses forever relinquished, released, waived and quit claimed "all property rights and claims that he/she now has or may hereafter have."

Another important factor in this case, and probably the most critical, was that the divorcing couple specifically stated in the divorce settlement agreement that each party was to "retain sole ownership of (his/her) separate retirement assets, free and clear from any claim by the other party." The divorce settlement agreement went on to explicitly name the retirement assets each party was to keep, including the 401k plan account subject to the litigation in the *Herbert* case.

As a result of these explicit legal provisions, the 401k beneficiary designation to the ex-spouse was effectively nullified and the 401k plan funds were distributed to the decedent's estate.

CONCLUSIONS

We can draw two important lessons from the *Herbert* case:

1. In a divorce settlement agreement or the like, it is critical to include specific references that clearly and unambiguously state a divorcing couple's intentions regarding their assets following the divorce, and to include clear and broad release language in the agreement to ensure the parties' true intentions will be fulfilled, even if one of them does not update her/his beneficiary designations. *Herbert v. Cunningham* exemplifies how a properly drafted divorce settlement agreement can help the estate of the first-to-die amongst a divorcing couple to recover an ERISA plan account, such as a 401k.

2. Despite the ruling in this case, it is important to take action and complete the necessary steps to update one's beneficiary designations during or after a divorce or domestic partnership separation to protect one's assets, preserve wealth, and avoid the high costs associated with litigation proceedings.

Keep in mind, the tax results of having one's estate designated as the beneficiary of one's ERISA plan account are significantly inferior to having a human designated as the beneficiary. This is true because human beneficiaries are allowed to stretch the distribution of an ERISA account over their remaining life expectancy and thus pay the income taxes due from the ERISA account over that time. An estate cannot stretch the distribution and tax payments for more than five years.

Furthermore, significant asset protection benefits can be realized if one has certain trusts named as the beneficiary of one's ERISA plan account. For example, if one designates a trust for her child as the beneficiary of her plan, the plan will be protected from the child's creditors. Anyone who chooses to rely on *Herbert v. Cunningham* to avoid the simple step of updating one's beneficiary designations should be warned that his or her estate will incur significant litigation expenses in order to obtain the relief the decedent's estate successfully obtained in the *Herbert* case.

We encourage those who are considering or have completed a divorce or domestic partnership separation to consult with an experienced estate planning attorney, in addition to a divorce attorney, to ensure all of your assets and interests are legally protected. Make sure to take the important first step of contacting your financial and legal advisers to revisit the beneficiary designations and ownership titling for your retirement and financial accounts, insurance policies and property or business holdings. Doing so can help you preserve your wealth and ensure that it passes to the appropriate parties after your death.

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